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Preface

This report for the year ended 31 March 2009 has been prepared for submission to the Governor under Article 151 (2) of the Constitution.

The audit of revenue receipts of the State Government is conducted under Section 16 of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971. This Report presents the results of audit of a review of 'Transition from Sales Tax to VAT'.

Audit observations on tax on sales, trade, etc.; taxes on agricultural income; taxes on vehicles; land revenue and building tax; other tax receipts and non-tax receipts alongwith general aspects are presented in a separate volume titled Report of the Comptroller and Auditor General of India (Revenue Receipts) for the year ended 31 March 2009 - Volume I - Government of Kerala.

Overview

Overview

This Report contains a review on 'transition from sales tax to VAT in Kerala' involving Rs. 295.24 crore. Some of the major findings are mentioned below.

- **The percentage of growth of revenue showed an inconsistent trend throughout the pre-VAT and post-VAT period from 2001-02 to 2008-09, though there was growth of revenue in absolute terms.**

  (Paragraph 2.1)

- **Shortcomings in the computerised system implemented by the department coupled with non-computerisation of all the check posts resulted in the returns of the dealers not being effectively scrutinised electronically by the assessing authorities.**

  (Paragraph 3.4)

- **Department is yet to prepare a comprehensive manual prescribing guidelines and norms for effective administration of VAT in the State.**

  (Paragraph 3.5)

- **The department was unable to furnish the number of assessments pending under the repealed Act and also assessments completed during the preceding years after implementation of the VAT which indicates weak monitoring mechanism.**

  (Paragraph 3.6)

- **Registering authorities did not obtain security of Rs. 5.73 crore from new dealers despite specific orders of the Commissioner of Commercial Taxes.**

  (Paragraph 4.3.1)

- **The department was unable to detect the un-registered dealers and bring them under the tax net due to absence of directives prescribing a system for monitoring surveys/raids.**

  (Paragraph 4.4.2)

- **The department has not prescribed a system for periodic scrutiny of the books of accounts of the dealers to verify whether a dealer has crossed the threshold of liability for payment of tax.**

(Paragraph 5.1.3.1)

- **There was no mechanism for monitoring the receipt and scrutiny of the returns. Test check by audit in two circles revealed short levy of tax of Rs. 21.77 crore including interest and penalty. Besides, assessing authorities incorrectly accepted CST returns which resulted in short levy of tax of Rs. 161.67 crore.**

(Paragraph 5.2.1 & 5.2.2)

- **There were deficiencies in the process of allowing input tax credits like non-circulation of list of cancelled registrations, allowance of claims on the strength of purchase list mentioning the registration numbers under the repealed Act, absence of cross verification of the records of the selling dealers etc. Test check in two circles revealed short levy due to excess availing of input tax credit of Rs. 1 crore including interest and penal interest.**

(Paragraph 6.1.3)

- **There was short demand of VAT compensation from Central Government by Rs. 93.69 crore due to failure to detect and rectify apparent misclassifications in revenue collection.**

(Paragraph 6.8)

- **Deviation from VAT design specified by the EPC resulted in loss of Rs. 1.30 crore.**

(Paragraph 6.9.1)

Chapter I
Introduction

CHAPTER I INTRODUCTION

1.1 Introduction

The Empowered Committee (EPC) of the State Finance Ministers set up by the Government of India in its meeting held on 23 January 2002 unanimously decided to introduce Value Added Tax (VAT) in all the States and Union Territories with effect from 1 April 2003. After several rounds of discussions they came out with a white paper in January 2005 defining the basic designs of the state level VAT. However, taxes on sales, trade etc., being a state subject, the states were allowed the flexibility to adopt appropriate variations in their VAT Acts, consistent with the basic design. The VAT system which is a destination/consumption based tax system has provisions for set-off of the tax paid on the previous purchases and seeks to address problems of double taxation of commodities, multiplicity of taxes, surcharge and additional tax on sales tax etc., in the sales tax structure that resulted in a cascading tax burden. Major designs put forth in the white paper are as follows:

- **Manufacturers and traders will be given input tax credit (ITC) for purchase of inputs-including that of capital goods-meant for use in manufacture or resale;**
- **ITC remaining unadjusted at the end of a year and also on export will be refunded to the dealers;**
- **Dealers will submit self assessment returns declaring their tax liability. These returns will be considered as deemed assessment except where notice for audit of books of accounts of the dealer was issued within the prescribed period;**
- **Audit of books of accounts of the dealer will be delinked from tax collection wing to remove any bias;**
- **There would be two basic tax rates of four *per cent* and 12.5 *per cent* plus a specific category of tax exempted goods and special VAT rate of one *per cent* only for gold and silver ornaments, precious stones etc; and**
- **Other taxes like turnover tax, surcharge, etc., to be abolished and phasing out of central sales tax (CST) and rationalisation of overall tax burden.**

The Government of Kerala implemented the Kerala Value Added Tax Act, 2003 (KVAT Act) with effect from 1 April 2005. Aviation turbine fuel, motor spirit, high speed diesel oil, petrol other than naphtha, foreign liquor, ganja and opium, however, continued to be administered under the Kerala General Sales Tax Act, 1963 (KGST Act). The major variations between the pre-VAT and post-VAT scenario are given in the annexure - I.

We undertook a review of the transition process from the sales tax regime to the VAT system.

1.2 Organisational set-up

Principal Secretary, Taxes administers the levy and collection of tax under KGST, KVAT and CST Acts at the Government level and the Commissioner of Commercial Taxes (CCT) at the departmental level in the Department of Commercial Taxes. The CCT functions with the assistance of Joint Commissioners (JC), Deputy Commissioners (DC) and Inspecting Assistant Commissioners (IAC). Assistant Commissioners (AC) in Special Circles and Commercial Tax Officers (CTO) in ordinary circles were in-charge of registration of dealers, scrutiny of returns and levy and collection of tax. There are CTOs (Works Contract) in each district exclusively for registration, scrutiny of the returns and levy and collection of tax on works contract.

1.3 Audit objectives

We conducted the review to ascertain the

- **promptness and effectiveness of planning for implementation of transition from the sales tax regime to VAT system;**
- **adequacy and effectiveness of the organisational structure;**
- **adequacy and proper enforcement of the provisions of the VAT Act and the Rules made thereunder to safeguard the revenue of the State;**
- **adequacy of and effectiveness of the internal control mechanism in the Department to prevent leakage of revenue; and**
- **status of the system after being in place for four years.**

1.4 Scope and methodology of audit

We conducted the review during May to September 2009, covering the period from 2005-06 to 2007-08. During the audit process, we collected data on registration, filing and scrutiny of the returns and grant of ITC on opening stock from the DCs through questionnaires issued through the office of the CCT. Data on preparedness and transitional process were gathered from the records in the office of the CCT and the Taxes Department of Government of Kerala. We have also scrutinised selected files at CTO, Special Circle, Thiruvananthapuram and CTO (Works Contract), Thiruvananthapuram.

1.5 Acknowledgement

On behalf of the Indian Audit and Accounts Department, we acknowledge the co-operation of the Commercial Taxes Department in providing necessary information and records for audit. Before taking up the review, we have organised an entry conference in May 2009 which was attended by the Principal Secretary (Taxes) who was also holding the charge of the CCT, DC (General) and DC (Audit & Inspection), wherein the scope and methodology of audit was explained to the department. An exit conference was also held in July 2009 by the Principal Accountant General with the Principal Secretary (Taxes) in which the findings of the review and the recommendations were discussed. After the exit conference, we have forwarded the draft review report to the Government/department in August 2009 requesting their response. We have included the replies of the Government/department during the exit conference and at other points of time in the relevant paragraphs of the review. We are happy to report that the Government have accepted most of our audit findings and recommendations.

1.6 Results of audit

Our review on 'Transition from Sales Tax to VAT system in Kerala' revealed a number of deficiencies in the transitional process, lacunae in the Act and Rules and other weaknesses of administration of the VAT. Also, we have noticed cases of non/short realisation of revenue worth Rs. 295.24 crore. These are discussed in seven succeeding chapters.

Chapter II
Financial analysis

CHAPTER II FINANCIAL ANALYSIS

Trend of revenue

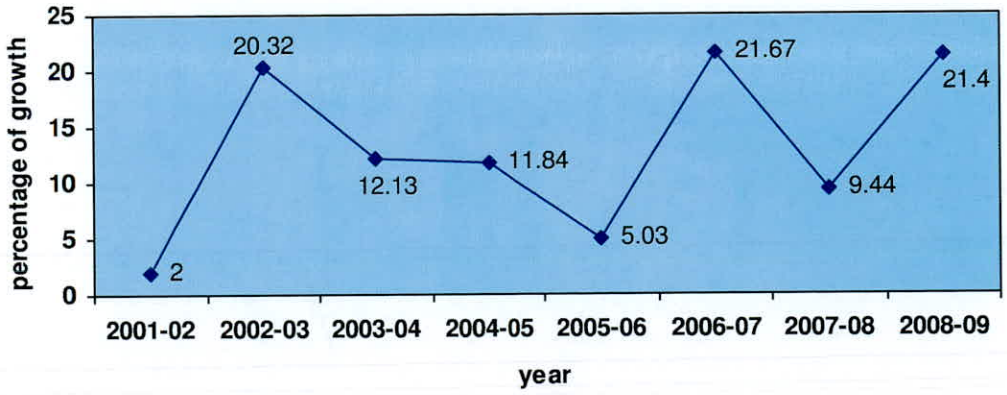
2.1 Pre-VAT and post-VAT tax collection

Our evaluation of the tax collection during the pre-VAT (2001-02 to 2004-05) and post-VAT periods (2005-06 to 2008-09) and the percentage of growth of receipts in each of these years indicated that there has been an increase of 2.82 *per cent* in average growth during the post-VAT period over the pre-VAT period. The percentage growth during the years 2001-02 to 2008-09 are shown in the charts below.

(Rupees in crore)

Pre-VAT			Post-VAT		
Year	Actual collection	Percentage of growth	Year	Actual collection	Percentage of growth
2001-02	4440.85	2.00	2005-06	7,037.97	5.03
2002-03	5,343.15	20.32	2006-07	8,563.31	21.67
2003-04	5,991.43	12.13	2007-08	9,371.76	9.44
2004-05	6,701.05	11.84	2008-09	11,377.13	21.40
Average growth		**11.57**			**14.39**

Chart showing percentage of growth



We noticed that though the revenue has been increasing in absolute terms during the pre-VAT as well as post-VAT periods, the percentage of growth of revenue during the pre-VAT and post-VAT period has been showing an inconsistent trend.

2.2 Variation between the budget estimates and actuals

Our analysis of the performance of the department during the post VAT period (2005-06 to 2008-09) indicated that though the department could

not achieve the targets fixed during 2005-06, 2007-08[1] and 2008-09, however, overall the department has done fairly well in achieving the targets as the variations were confined to about six *per cent*.

(Rupees in crore)

Year	Budget estimates (revised)	Actuals	Variaton of actuals over budget estimates	Percentage of Variation
2005-06	3,134.00	2,955.81	(-) 178.19	(-) 5.69
2006-07	4,135.00	4,189.58	(+) 54.58	(+) 1.32
2007-08	5,129.67	5,014.80	(-) 114.87	(-) 2.24
2008-09	6,218.35	5,881.96	(-) 336.39	(-) 5.41

After we pointed out the variation, the Government stated that the decrease in VAT collection during 2007-08 was due to reduction of tax on certain commodities from 20 *per cent* to 12.5 *per cent*.

2.3 Comparison between the VAT/sales tax receipts vis-à-vis the total (tax and non-tax) receipts of the State

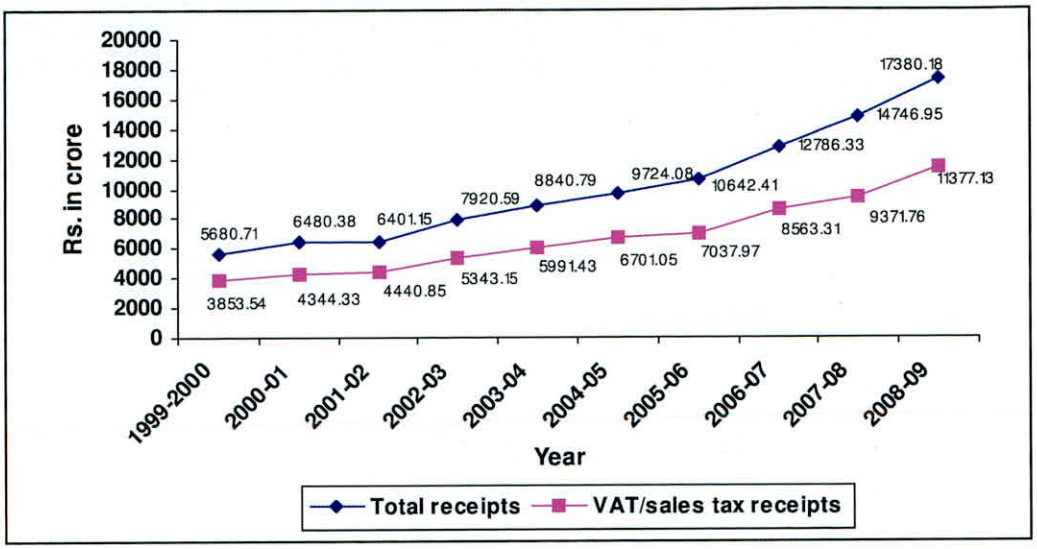
The comparison between the VAT/sales tax receipts *vis-à-vis* the total (tax and non-tax) receipts of the State during 1999-2000 to 2008-09 is shown in the table and chart below.

(Rupees in crore)

Year	Total receipts	VAT/sales tax receipts	Percentage of VAT/Sales tax receipts over the total receipts
1999-00	5,680.71	3,853.54	67.84
2000-01	6,480.38	4,344.33	67.04
2001-02	6,401.15	4,440.85	69.38
2002-03	7,920.59	5,343.15	67.46
2003-04	8,840.79	5,991.43	67.77
2004-05	9,724.08	6,701.05	68.91
2005-06	10,642.41	7,037.97	66.13
2006-07	12,786.33	8,563.31	66.97
2007-08	14,746.95	9,371.76	63.55
2008-09	17,380.18	11,377.13	65.46

[1] If misclassification pointed out in paragraph 2.5 were also reckoned, decrease of actuals over budget estimate during 2007-08 would be Rs. 327.46 crore (6.35 *per cent*).

ST/VAT receipts *vis-a-vis* total receipts



The table and the chart above shows that VAT/sales tax receipts remained in the range of 63.55 to 69.38 *per cent* of total state receipts during ten year period upto 2008-09. However, the percentage share of VAT/sales tax in total receipts which was 67.84 *per cent* during 1999-2000 went up to 69.38 *per cent* in 2001-02 but fell to around 65 *per cent* in 2008-09.

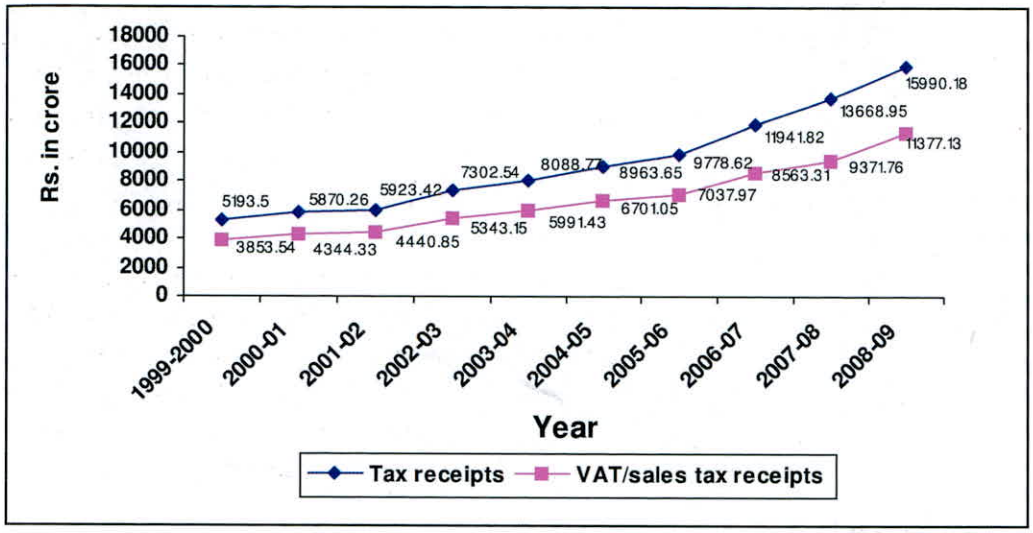
2.4 Comparison between the VAT/sales tax receipts *vis-à-vis* the tax receipts of the State

The comparison between the VAT/sales tax receipts vis-à-vis the tax receipts of the State during 1999-2000 to 2008-09 is shown in the table and chart below.

(Rs in crore)

Year	Tax receipts	VAT/sales tax receipts	Percentage of VAT/Sales tax receipts over the total tax receipts
1999-00	5193.50	3,853.54	74.20
2000-01	5,870.26	4,344.33	74.01
2001-02	5,923.42	4,440.85	74.97
2002-03	7,302.54	5,343.15	73.17
2003-04	8,088.77	5,991.43	74.07
2004-05	8,963.65	6,701.05	74.76
2005-06	9,778.62	7,037.97	71.97
2006-07	11,941.82	8,563.31	71.71
2007-08	13,668.95	9,371.76	68.56
2008-09	15,990.18	11,377.13	71.15

ST/VAT receipts vis-a-vis total tax receipts



The table and the chart above shows that during ten year period upto 2008-09 VAT/sales tax receipts constituted 68.56 to 74.97 *per cent* of total tax receipts of the State. However, the share of VAT/sales tax in tax receipts of the State which was 74.20 *per cent* in 1999-2000 came down to 71.15 *per cent* in 2008-09.

2.5 Post-VAT collection of ST, CST and VAT

The total tax on sales, trade etc., raised by the State, split up of receipts under KGST, CST and KVAT, percentage of increase in VAT collection from previous year and percentage of VAT revenue to the total tax revenue during the years 2005-06 to 2008-09 are shown in the table below.

(Rupees in crore)

Year	Total tax on Sales, trade etc.	Receipts under minor head for[2]			Percentage of increasein VAT Collection	Percentage of VAT on tax on sales, trade etc
		KGST Act	CST Act	KVAT Act		
2005-06	7,037.97	3,297.26	486.36	2,955.81	----	42.00
2006-07	8,563.31	3,882.04	339.66	4,189.58	41.74	48.92
2007-08	9,371.76	3,334.96	1,016.21	5,014.80	19.70	53.51
2008-09	11,377.13	5,035.19	425.38	5,881.96	17.29	51.70

Analysis of the figures in the table above brought out the following.

The KVAT figure for 2005-06 is the net collection after setting off ITC on opening stock of the dealers as on 1 April 2005 which may be the reason

[2] Revenue of other miscellaneous minor heads not shown separately.

for recording higher percentage of increase during 2006-07 than 2005-06.

The growth of VAT collection as seen in the column 6 shows that though the receipts increased in absolute terms, the percentage of growth registered a decreasing trend over the years 2005-06 to 2008-09.

During 2007-08, revenue under KGST had decreased by Rs. 547.08 crore (14.09 *per cent*) and that under CST had increased by Rs. 676.55 crore (199.18 *per cent*) in comparison to the figures of 2006-07. Considering the price rise in the non-VAT goods and the reduction in the floor rate of CST from four *per cent* to three *per cent* during 2007-08, such huge variation could not be possible. However, the department did not take any action to reconcile the figures as required under the Kerala Financial Code and locate the misclassification. This was despite the fact that the Central Government used to grant VAT compensation on the basis of the reconciled figures.

On scrutiny of the major remittances for 2007-08, we detected misclassification that ultimately resulted 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 head. Consequent short claim of VAT compensation of Rs. 93.69 crore for the year 2007-08 is enumerated in paragraph 6.8.

Government stated that though misclassification occurred during the initial period of introduction of VAT, the department reconciled, identified them and effected changes in the treasury records. The fact remains that we have referred to the final figures booked by the Accountant General (A&E), Kerala. Once the accounts are completed, no further change is possible in the treasury accounts. Though a note of error can be effected in the accounts of AG (A&E), the department did not make any such effort.

2.6 Cost of collection

The gross collection under 'Taxes on sales, trade etc.,' and expenditure incurred on its collection during the years 2004-05 to 2008-09 are shown in the table below.

Year	Total tax on Sales, trade etc. (ST+VAT)	Expenditure on collection of revenue	Percentage of expenditure to gross Collection	All India average of the relevant year
	(Rupees in crore)			
2004-05	6,701.05	52.10	0.78	0.95
2005-06	7,037.97	60.96	0.87	0.91
2006-07	8,563.31	78.21	0.91	0.82
2007-08	9,371.76	89.75	0.96	0.83
2008-09	11,377.13	102.59	0.90	Not available

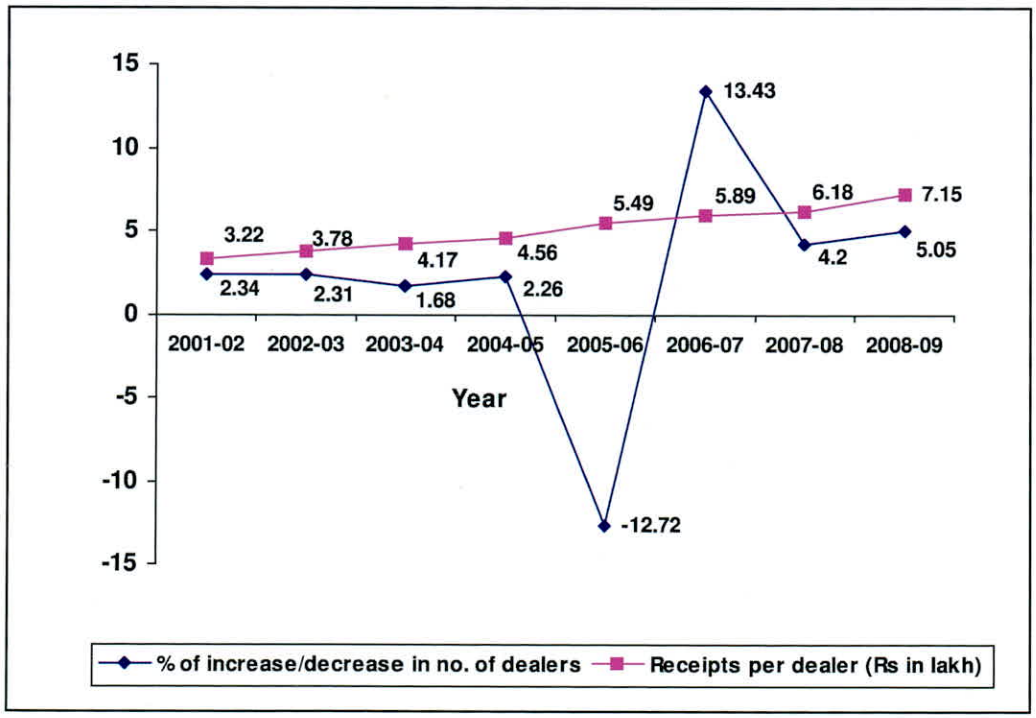
The cost of collection, which was 0.78 *per cent* of the gross collection during 2004-05, had increased up to 0.96 *per cent* during 2007-08 while it decreased to 0.90 *per cent* during 2008-09. However, the cost of collection, when compared to the all India average for the relevant year, was lower during the years 2004-05 and 2005-06 while during the next two years it was marginally higher.

2.7 Receipt per dealer

The number of registered dealers during the period from 2001-02 to 2008 09 vis-à-vis receipt per dealer is shown in the table and chart below.

Period	Number of dealers	Percentage increase (+)/decrease (-) of dealers with reference to previous year	Actual receipts (Rupees in crore)	Receipts per dealers (Rupees in lakh)
2001-02	1,38,100	_ ._	4,440.85	3.22
2002-03	1,41,290	2.31	5,343.15	3.78
2003-04	1,43,669	1.68	5,991.43	4.17
2004-05	1,46,909	2.26	6,701.05	4.56
2005-06	1,28,220	-12.72	7,037.97	5.49
2006-07	1,45,439	13.43	8,563.31	5.89
2007-08	1,51,550	4.20	9,371.76	6.18
2008-09	1,59,207	5.05	11,377.13	7.15

Number of dealers vis-a-vis receipts per dealer



Thus, during the period of 10 years, the receipts per dealer has grown steadily and during 2008-09 it registered a healthy trend of Rs. 7.15 lakh per dealer. However, the number of registered dealers recorded a decrease of 12.72 *per cent* in the year of implementation of VAT which is apparently due to raising of threshold limit for registration from annual turnover of Rs. 1 lakh to Rs. 5 lakh.

Chapter III
Preparedness and transitional process

CHAPTER III PREPAREDNESS AND TRANSITIONAL PROCESS

3.1 Preparation of VAT Act/Rules, Vetting of the Act and Rules by the Government of India and approval of the Legislature

The department completed drafting of KVAT bill in association with the Centre for Taxation Studies[3] (CTS). The draft KVAT Bill was then sent to the Government of India for vetting on 27 December 2002. The Legislature passed the KVAT Bill on 27 February 2003 and it got the assent of the President on 10 December 2004. The Government notified the Act on 27 December 2004 and published the KVAT Rules on 31 March 2005 and VAT was implemented in Kerala from 1 April 2005.

3.2 Creation of awareness among the stake holders

The CTS conducted three state level conferences for discussion of draft VAT Act during 2002-03 and 85 one-day tax payers awareness programme/seminar on VAT in all districts in association with the trading/ business organisations during 2004-05. A 16 page booklet on VAT was also published through the Public Relations Department and salient features of the VAT system was advertised through electronic and print media. The department had also established the facility of a 24 hour toll free telephone service to clarify issues in connection with VAT. The Government constituted following committees having representation from major trade associations to sort out issues of implementation of VAT, 1) State Level Consultative Committee (SLCC) with Finance Minister as the chairman, convened once in six months, 2) Executive committee of SLCC which would meet once in two months, 3) District Advisory Committee under the chairmanship of DCs which meet on second Wednesday of every month.

3.3 Analysis of staff requirement and Re-organisation of the Taxation Department

The Taxes Department retained all the existing five wings[4] during re-organisation also. However, they deployed more ACs and CTOs for audit assessment and during the first two years they entrusted the duty of completion of the pending KGST assessments to 105 out of 327 CTOs of assessment wing. Under KVAT Act, DC (Appeals) is the first appellate authority whereas it was Appellate Assistant Commissioner under the

[3] An autonomous institution established in 1992 by the Government of Kerala to promote and undertake research, training, consultancy and publication in the field of public finance, taxation law, management and accounting.

[4] Appellate Wing, Assessment Wing, Audit Wing, Intelligence Wing and Legal Wing.

KGST Act. The Department reduced their number from 16 to 8. Despite our specific request, the department did not furnish the wing-wise staff position consequent to recent re-organisation of the audit assessment wing.

3.4 Computerisation of the Taxation Department and the check posts and their interlinking

The Department had completed computerisation and wide area network (WAN) networking of all circles by 2006. However, the details of electronically filed returns for 2007-08 onwards only are available in the system. The Department also informed us that it was a Government policy to computerise only A & B class[5] check posts. The Department completed computerisation and networking of 14 out of 81 check posts (six A class, five B class, 32 C class and 38 temporary check posts) by March 2009. From January 2009, TIN dealers have to mandatorily e-file the returns. However, we feel that e-returns can be effectively cross verified with the information available in the check posts only if all the remaining check posts are brought under WAN.

The Commercial Taxes Department has provided us with a dedicated username and password to have access to the computerised database for audit scrutiny. We are thankful to the department for giving us the access to its database.

We observed the following deficiencies in the software 'Kerala VAT information system' while attempting to retrieve certain data from the database.

- Searching dealers by name did not yield result in some of the cases. This was mainly due to granting of registration either in the name of the dealer or in the name of the business concern.
- Software did not have any provision to generate commodity wise list of major dealers.
- Field used by the software for crosschecking of purchase and sale is invoice number. Addition of some letters as codes by some purchasers in invoice number makes the comparison difficult.
- Software did not have an audit module.

Government stated that the department completed WAN networking of offices, that number of check posts running offline is 60 and that they had issued necessary instruction to IT Management Cell to consider suggestions put forth by us.

[5] Check posts were classified as A, B and C based on the number of vehicles passing through these and revenue collected.

We recommend that, besides the points mentioned above, the department may also consider the following.

While verifying enclosures such as purchase list, sale list etc., of periodical return, current status of the dealer, i.e., active or cancelled or unregistered, gets displayed in a column beside the TIN. Since status of the dealer is the most relevant information while admitting input tax credit (ITC) claim, another column in the return for displaying date of registration, cancellation etc., would be useful.

3.5 Creation of manuals and training of the staff

The CCT by an order on 31 August 2004 constituted six committees for preparatory work on introduction of the VAT. This included a Committee on Manual, Registration and Forms. However, we found that the Department have not prepared a Manual on VAT so far (April 2010) and consequently, the CTOs are not maintaining any records other than those related to creation of additional demand and collection of tax.

The department alongwith the CTS conducted various programmes on VAT awareness from 2001-02 onwards, which included four state level seminars and 30 awareness programmes on VAT during 2001-02. They also conducted 60 such programmes in association with various trade/ manufacturing associations during 2002-03.

The department conducted training on general principles and issues on VAT for the officials, in CTS during 2001-02 and in-depth presentation and discussion on draft bill and rules and procedures of registration, acceptance of return, audit assessments etc., during 2002-03. The CTS had given VAT related training to the officials of the rank of CTOs and above during that year. They conducted VAT statute course for the CTOs and additional CTOs during 2004-05 and KVAT introduced statutory forms during 2005-06. The department had also arranged for separate induction courses for directly recruited and newly promoted CTOs. Consequent to introduction of the KVAT software (KVATIS), the department imparted computer training on the software to its officers during 2006-07 and 2007-08.

We recommend that the department may bring out a comprehensive manual on VAT specifying the procedures for administration of KVAT Act and Rules made thereunder and prescribing registers to be maintained in each wing of the department.

3.6 Completion of KGST/CST assessments

The Kerala Finance Act 2007 inserted Section 17D in the KGST Act to complete the KGST assessments pending as on 1 April 2007 under fast track method before 31 March 2008, by a team of officers constituted by

the CCT. The team had to complete the assessment fairly by summary proceedings. They were empowered to give reasonable concession on estimation of suppression of turnover. As the department could not complete all the pending assessments during that year, the Government extended the period first to 31 March 2009 and then to 31 March 2010.

In our opinion, the decision to subject all pre-VAT cases to assessment was laudable. However, the department could not furnish the details of the KGST assessments pending completion and number of assessments completed each year from 2003-04 onwards. This shows that the department was not effectively monitoring disposal of the assessments of the pre-VAT period under the fast track method.

We recommend that the department may exercise more control over the completion of assessments of pre-VAT period to ensure that the assessments under fast track was effective and there was no leakage of revenue.

3.7 Collection of arrears of taxes due under KGST and CST Acts

We analysed the arrears of receipts under the KGST and CST Act pending collection at the end of each year, arrears realised during each year from 2004-05 to 2008-09 as furnished by the CCT and found that there was a sudden increase in the arrears during 2006-07, substantial decrease during 2007-08 and 2008-09. Despite our specific requests, the department has not intimated the reasons for such abnormal movement of the figures. Also, the percentage of collection of arrears was negligible and remained well below five per cent which is a matter of concern.

(Rupees in crore)

Year	Arrears under KGST/CST	Arrears collected	Percentage of collection
2004-05	2,777.23	60.43	2.18
2005-06	3,094.02	62.06	2.01
2006-07	12,948.05	101.88	0.79
2007-08	4,425.47	67.72	1.53
2008-09	3,328.56	145.66	4.38

The Government introduced (April 2008) a scheme for clearing of arrears, under which, the AAs could waive 100, 95 and 90 per cent of interest and penalty on demands pertaining to the period upto 31 March 1996, 31 March 2000 and 31 March 2005 respectively, if the dealer opted for payment of arrears before September 2009 or such other notified date. In the case of demand upto March 1991, 25 *per cent* of tax was to be waived.

Despite these desperate efforts, the department could collect only Rs. 145.66 crore during 2008-09 out of the arrears of Rs. 3,328.56 crore.

We are of the opinion that huge pendency of arrears and subsequent loss of revenue on account of various waivers announced by the Government are results of ineffective monitoring coupled with non-initiation of timely action for recovery of Government dues over the years.

We recommend that the department may install a strong mechanism for monitoring the arrears and take time bound action to recover them. They may also consider fixing responsibility on the officer-in-charge for non-recovery of dues under his charge.

Chapter IV
Registration and database of dealers

CHAPTER IV REGISTRATION AND DATABASE OF DEALERS

4.1 Creation of database of dealers

The Department started allotting computer generated numbers to the dealers from April 2005 onwards though the system of registration was manual. The computerised registration process started from October 2006 onwards and from February 2007 onwards, the department is also effecting cancellation of registration through intranet.

As per the information furnished to us by the department, there were 1,32,039 TIN dealers, 21,774 PIN dealers and 4,074 compounded tax dealers in the State as on April 2009.

4.2 Carrying forward of the database of dealers under the KGST Act and confirmation of the securities provided by them

Dealers registered under the KGST Act whose turnover during 2004-05 was Rs. 5 lakh or above were liable to obtain registration under the KVAT Act on or before 20 April 2005, on payment of fee applicable to renewal. The Government amended the Rules to extend the period to 15 February 2006. As per the provisions, security/additional security was not payable by the KGST dealers continuing the registration under the KVAT Act. The department allowed the dealers to carry over the security, if any, furnished under the KGST Act, during the VAT period also.

The Department informed us that during introduction of VAT, they had granted either PIN or TIN to all the dealers having KGST registration. We found that the information furnished was not fully correct as there was a reduction of 12.72 *per cent* in number of dealers in the first year of implementation of the VAT system. However, scope of major dealers evading registration was less. Our study of the registration process in 15 DC offices[6] revealed the following deficiencies.

- Details of dealers registered under the KGST Act were available in the manual register of Registered Dealers (R Register) maintained in the circles while these were not available in the database. The number of dealers under the KGST Act as on 31 March 2005 was 1,42,821 while the number of assessees during 2004-05 as per data furnished by the CCT was 1,46,909. We found that the DCs of the circles covered in this review failed to fill the intended proforma properly in most of the cases which not only resulted in the aforesaid variations between the figures of DCs and the CCT but also made it

[6] Alappuzha, Ernakulam, Idukki, Kannur, Kasargod, Kollam, Kottayam, Kozhikode, Malappuram, Mattanchery, Palakkad, Pathanamthitta, Thiruvananthapuram, Thrissur and Wayanad.

impossible for us to carry out a comparison of dealers who were registered under the KGST Act but not registered under the KVAT Act.

- The registration is effective from the date of filing valid application. The CCT directed in October 2006 that the RAs should permit those who had paid the prescribed fee before 15 February 2006 to file application upto 31 October 2006 and that the status of such dealers would be that of registered dealers with effect from 1 April 2005. The instruction contravened the provisions of the KVAT Act and provided undue benefit to the dealers as they were eligible for the ITC for the period during which they had no registration at all. As per data furnished to us by the DCs of the circles test checked, the benefit of this circular was granted in 7,741 cases.
- The Registering Authorities (RAs) could permit dealers to whom provisions of the Act apply to use the registration certificates issued under the KGST Act only upto 30 June 2005. The Government amended the rule in April 2007 to allow such dealers time till 15 February 2006 to submit application for registration under the KVAT Act. This amendment contravened the provisions of the Act.

After we pointed out the anomally, the Government stated that the circular applied to those who had remitted fee on or before the cut off date prescribed in the Rules, for switching over to VAT registration. By payment of renewal fee they have substantially complied with the provisions of the Act and it is only a matter of regularisation. The reply was not relevant as our comment was that the Rule and the circular contravened the provisions of the Act. While allowing deviations from the provisions of the Act, the Government should have suitably amended the Act also.

4.3 Registration of new dealers

4.3.1 Grant of new registration without security

The KVAT Act permits, the RAs to demand from the dealers applying for registration, an amount not exceeding fifty *per cent* of the tax payable on the turnover as security. The CCT in June 2005 directed that the RAs could grant registration without security if the dealer is not likely to default in payment of tax after recording the reasons for arriving at such a conclusion and the evidences relied upon. However, in February 2006 the CCT fixed the rate of security to be realised from individual/ proprietorship, partnership firm and company at Rs. 5,000, Rs. 10,000 and Rs. 25,000 respectively. Applicants requiring CST registration should pay a security of Rs. 10,000, Rs. 25,000 and Rs. 50,000 respectively. Dealers in goods included in the first schedule only and those opted for presumptive tax need not furnish security.

We noticed that the RAs granted 4,226 fresh KVAT registrations during 2006-07 and 2007-08 without obtaining security as prescribed by the CCT. Moreover, the RAs under DCs of Kottayam and Ernakulam granted 23 and nine CST registrations respectively, without sufficient security. Amount of security involved was Rs. 5.73 crore calculated at the average rate of security fixed.

After we pointed out the mistake, the Government stated that the Act requires the RAs to demand security only if they have reason to believe that the dealer is likely to default payment of tax and hence demand of security was not mandatory. Besides, the amount can be deposited in securities and is liable to be returned and hence, it is not a short levy. However, the fact remains that the CCT issued the circular to curb unfettered discretion of RAs in this regard and the Apex Court had held[7] that the circular directions issued by the Commissioner is binding on the departmental officers.

4.3.2 Incorrect grant of PIN

A dealer would not be eligible to opt for presumptive tax if aggregate sales turnover under KVAT Act or KGST Act exceeded Rs. 50 lakh during the preceding year to which the option related. Turnover of sale of medicine purchased from the dealers who have opted for payment of tax on maximum retail price (MRP) was the only exception. The CCT, however, directed in February 2006 that RAs could permit petroleum dealers to opt for payment of presumptive tax, if the turnover in respect of sale of goods to which the provisions of KVAT applies was below Rs. 50 lakh. The Government also suitably amended the KVAT Rules with effect from 31 December 2007.

We found that the RAs allowed 278 dealers of petroleum products to pay presumptive tax. The amendment to the rule was void as it was against the provisions contained in the Act and can be implemented only through an amendment to the Act.

After we pointed out the mistake, the Government stated that the decision to allow petroleum dealers to opt for compounded tax on VAT items was only for easy administration of tax and does not have a revenue impact. The reply did not touch upon the issues raised by us which was about inconsistency with provisions of the Act.

4.4 Detection of unregistered dealers

The KVAT Act empowers any officer not below the rank of assessing authority (AA) to enter any place of business and inspect any accounts or documents relating to the business to ascertain the liability for registration.

[7] Padinjarekkara Agencies Ltd. Vs State of Kerala (SC) 18(KTR) 21

We feel that there is a need to improve the inspection activities of the department as we found deficiencies in the process of detecting unregistered dealers as discussed below.

4.4.1 Non-registration of those liable for registration

4.4.1.1 A dealer in CTO, Second Circle, Thrissur purchased packing cases for Rs. 71.42 lakh during 2006-07 from five unregistered dealers whose total turnover exceeded Rs. 5 lakh. The RA, however, failed to get them registered and collect tax of Rs. 2.86 lakh and twice the amount as penalty. This resulted in non-levy of Rs. 8.57 lakh.

After we pointed out the deficiency, the Government stated that the department had verified the accounts of the dealer and it revealed that all five persons involved had not exceeded the minimum turnover prescribed for registration. The reply furnished is not acceptable as we have copies of the purchase lists which show that those five dealers had turnover exceeding Rs. 5 lakh each and were thus, liable for registration and payment of tax and penalty.

4.4.1.2 Every casual trader shall, within 24 hours of his arrival in the State, intimate the RA his name, address, nature of the goods he intends to deal with and the period within which he intends to leave the jurisdiction of such authority. He shall also submit an application for registration as per the provisions of the Act.

Our analysis of the data received from DCs except DC, Alappuzha and Pathanamthitta revealed that during 2005-06 to 2007-08, only 487 casual dealers had applied for registration in the State, of which 251 were at Ernakulam. This showed that the number of registrations granted in remaining 12 districts were only 236.

After this was pointed out by us, the Government stated that the statistics is available only in respect of the registration granted to the casual dealers by the AAs of the circles. However, Intelligence Squad as well as check post personnel had collected registration fee alongwith security deposit from casual traders, while disposing the cases detected at their level. The reply confirms that the number of dealers registered was less. Also, the fact remains that the security deposit obtained from these dealers is only a token money without any consideration of the volume of business which can only be ascertained by proper assessment at the circles.

4.4.1.3 As per the KVAT Act, registration is compulsory for any State/ Central Government/Union Territory or any department thereof or any local authority or any autonomous body, irrespective of the quantum of total turnover. For this purpose, the authorised officer is required to submit an application in form 1E. However, only autonomous bodies need to pay fee for registration/renewal. Minimum fee for the registration

is Rs. 500 and fee for renewal of registration by a dealer who is not an importer is Rs. 500.

We have analysed the list of registrations granted in the State on the basis of form IE applications and noticed the following deficiencies.

- Atleast 202 and 127 autonomous bodies of the Central Government and the State Government respectively liable to obtain registration from 2005-06 were not registered. This resulted in loss of fees for registration as well as fee for subsequent three renewals, which amounted to Rs. 6.58 lakh.
- 1,082 (88.47 *per cent*) out of 1,223 local bodies in the State were not registered though all of them were awarders of works contract. In four districts[8], no local body was registered while in another four[9] districts, only one local body each was registered.
- Only two out of 13 Central Public Works Department offices (one each at Ernakulam and Thrissur) and 13 out of about 63 State public works offices (eight at Kollam and five at Thrissur) and few offices of the Irrigation Department and the Kerala Water Authority were registered, even though most of them were awarders of works contract.
- Apart from the above two CPWD offices and CSD canteen, no Central Government offices were registered under the KVAT Act.

The unregistered institutions among the above would not file mandatory returns showing works awarded, tax deducted at source from contractors, details of purchase and sale effected etc. Consequently, there is no mechanism to cross verify the records of the Works Divisions and buying Departments in the case of works/ supply contractors to confirm whether the dealers have actually included the turnover in corresponding returns and paid tax.

After we pointed out the deficiency in registration process, the Government stated that the audit objection was not correct as only departments/institutions having turnover of sale need to be registered, irrespective of total turnover and that it is the responsibility of the awarder to deduct tax at source from every payment made to contractors including advance payment. The fact remains that most of the departments/ institutions may have sales turnover atleast on sale of unusable items for which they may collect tax also. Registered dealers liable to tax only can collect tax under the Act. Registration and filing of return by them serve as a mechanism to ascertain, whether the dealers are including in the return atleast major sales and work contracts receipts from such institutions and whether they are deducting tax at source on works contract payment.

8 Alapuzha, Pathanamthitta, Thiruvananthapuram and Wayanad.
9 Idukki, Kannur, Kasargod and Kottayam.

The Government may ensure that all Central/State Government departments, local authorities and autonomous bodies comply with the statutory requirement of registration and filing of return.

4.4.1.4 Every clearing or forwarding agency, transporting agency, shipping agency, railway authorities etc., should submit to the AA by 10th of the subsequent month, a monthly return of all goods, they cleared, forwarded, transported or shipped. The CCT directed in October 2006 and July 2007, that the parcel/courier clearing and transporting agencies would be categorised as dealer and every such agency operating in Kerala should take registration in the circles, where their headquarters function.

We found that though there are many courier agencies in Kerala, only four agencies under DC Ernakulam, had taken registration so far. Even railway authorities had not obtained registration. Due to non-registration of these agencies, the purpose of the provision to keep a watch on the purchases/sales of the dealers by monitoring the returns of these agencies got defeated.

4.4.2 Deficiency in detecting unregistered dealers

Our analysis of the data furnished by the DCs of the circles test checked revealed the following deficiencies in the process of detecting unregistered dealers.

4.4.2.1 During the years 2005-06 to 2007-08, the department has granted 1,053 registrations on the basis of special drives. This shows that on an average, each day only one unregistered dealer was detected throughout the State. The department stated that they conducted a special drive to identify dealers liable for registration during October and December 2005, but the results were not made available to us.

4.4.2.2 The KVAT Act (1 July 2006) provides for detection of the dealers who have evaded registration through survey, inspection or enquiry and their compulsory registration, issuing a separate set of district-wise registration number. However, they shall not be entitled to any benefits accruing from such registration unless they obtain normal registration. Details furnished by the DCs revealed that the department granted compulsory registration under the above provision in 170 cases in eight districts[10], of which, 96 dealers obtained normal registration. No such registration took place in the remaining seven districts.

We found that though the provision for registering the unregistered dealers existed in the KVAT Act and an Intelligence Wing existed, the department did not issue any further directions prescribing a system for monitoring the surveys/raids.

[10] Alappuzha, Kollam, Kottayam, Kozhikode, Malappuram, Mattanchery, Palakkad and Thrissur.

After we pointed out the deficiency, the Government stated that there was good response from trading community to the special registration drive introduced through Finance Act 2006.

We feel that there is a need for the department to streamline the process of detection of unregistered dealers by issuing directives prescribing a system for monitoring the surveys/raids.

4.5 Cancellation/suspension of registration of dealers

4.5.1 Cancellation of registration by the dealers

A dealer discontinuing the business should file annual return within fifteen days, covering the period upto the date of discontinuance. He should also surrender any unused declaration(s) remaining in stock with him and ITC availed of on goods remaining unsold on closure of the business should be assessed as reverse tax.

From the records of CTO, Special Circle, Thiruvananthapuram, we found that 55 dealers had cancelled registration during the period of this review. In the absence of any monthly return, cancellation orders etc., in any of the cases, we could not ascertain whether the AAs followed the conditions prescribed for cancellation.

4.5.2 Cancellation of registration by the department

The registering authority can cancel or modify the registration of a dealer, if he has committed the offence of evasion of tax more than once during a year or obtained registration by fraud or misrepresentation of facts or have claimed ITC or refund of input tax on the strength of forged or bogus documents or has not been paying tax collected consecutively for a period of 3 months etc. The AA cancelling the certificate of registration should publish the details in atleast two leading dailies in the State and also in the website of the Commercial Taxes Department.

During the period of review, dealers cancelled 13,221 registrations and the department cancelled 2,023 registrations *suo motu*. The department did not publish the cancellation of registration in any of the cases either in dailies or in the departmental website.

After we pointed out the mistake, the department stated that the official website of the department provides TIN search facility and while searching, the word 'active' will appear in status column if the dealer is live and 'cancelled' will appear if the dealer had cancelled registration. The reply of the department overrides the statutory requirement. Publishing the cancellation of dealers in the website will not only enable any viewer to know about the dealers whose registrations are cancelled but also alarms the various branches of the department like the check gates, intelligence

wings, while in the present system being followed by the department, specific search has to be made to find out the dealers whose registrations are cancelled. Besides, in this system the date of cancellation of registration which is of paramount importance in confirming ITC claim, will not be displayed.

4.5.3 Suspension of registration

The KVAT Act empowers the DCs to suspend registration of any dealer for a period not exceeding six months for violation of conditions of the registration certificate or the provisions of the Act or Rules made thereunder. Similarly, DCs can resort to suspension of registration for a period of six months to one year if the dealer had evaded tax exceeding Rs. 1 lakh during a year.

We found that suspension of registration has been resorted to only in one case during the period 2005-06, though there had been a number of cases of violation of the provisions of the Act or evasion of tax. Besides, the details of the suspended case were also not published as required.

As tax paid on purchase from dealers whose registration is suspended or cancelled is not eligible for ITC, we recommend that the department may strictly enforce the provisions in the Act for publishing the details of cancelled and suspended registration in departmental website.

We also recommend that the department may take up the matter with the Ministry of Finance, Government of India for making sufficient provisions in the TINXSYS website for uploading such information which will help in alarming the other States about the cancellation of the registration of the dealers.

4.6 Periodic analysis of registration certificates to detect dormant registrations

The KVAT Rules, empowers the DCs to cancel registration of a dealer if he continues the registration without any transaction for a continuous period of two years.

We noticed that though more than 3,700 dealers on an average did not file any return every year, there is no mechanism in the department to check whether such dealers were actually continuing business or not. If the above dealers were conducting any business and collecting tax, the collected tax would be retained by them and the subsequent dealers can claim ITC which would be an additional burden on the Government. This proves that while switching over the entire lot of dealers from the KGST Act to KVAT Act, the department did not properly analyse the profile of the dealers remaining dormant, leaving scope for evasion of tax.

Consequent to the introduction of e-filing, detection of dormant dealers has become easy. We recommend that the department install a mechanism of periodic review of the TINs to detect dormant registrations and cancel such registration to avoid misuse of registration certificates and to reduce the scope of claims for inadmissible ITCs.

4.7 Determination of opening stock under the KVAT Act

Under the KVAT Act, dealers claiming ITC on opening stock as on 1 April 2005 were required to declare their opening stock. Further, in the case of dealers whose total turnover exceeded Rs. 40 lakh and who were required to file P & L account for 2005-06 along with annual return, it was possible to verify whether opening stock of the year tallied with that of closing stock for 2004-05 under the KGST Act. However, in the case of those who had not filed the accounts, such a cross checking was not possible. During the period of review, more than 35 *per cent* of the dealers did not submit either P&L account or closing stock inventory thus hindering effective scrutiny of the returns. **We found that apart from the above cases, the KVATIS software do not have provision for uploading the stock position of the dealers for future reference. Such a provision would have served as a tool to ascertain without reference to previous assessment records, the purchase price of goods sold and possible suppression of sales turnover, excess claim of ITC etc.**

Conceding of closing stock less than that disclosed in the P&L account, points to suppression of sales turnover or deficit stock. We noticed that, actual stock of vehicle and spare parts as per stock inventory for 2006-07 of a dealer in motor vehicles in CTO, Nedumangad, was for Rs. 9.03 lakh as against Rs. 18.89 lakh disclosed in the P&L account. Output tax at 12.5 *per cent* on the differential value of Rs. 9.86 lakh alone worked out to Rs. 1.23 lakh. Total short levy including interest and penal interest worked out to Rs. 2.19 lakh.

While confirming rectification being done by the department, the Government stated that the issue of major revenue consequence during transition period was ITC on opening stock, which was more or less effectively monitored. We are of the opinion that availability of such a database in KVATIS would enable the department to match the stock position mentioned in the return without referring to the previous return or assessment and would also be an impetus for effective monitoring on the dealers.

We recommend that the department may insert a provision for uploading the stock position in the KVATIS software or consider amending the software so that the opening stock declared in a return can be mapped with the closing stock shown in the previous return.

Chapter V
Returns, their scrutiny and audit assessment

CHAPTER V RETURNS, THEIR SCRUTINY AND AUDIT ASSESSMENT

5.1 Returns

Registered dealers as well as those liable to be registered under KVAT Act are required to file monthly/quarterly as well as annual returns, showing the details of total turnover, turnover on which exemption is claimed, taxable turnover, output tax due, tax collected, ITC availed of, tax due including reverse tax, if any, and the tax paid separately for that return period.

5.1.1 Deficiencies in forms for submitting returns

Annual returns are to be filed in form 10. The Government have prescribed separate forms of return from 10 A to 10 F for presumptive tax dealers, works contractors, awarders of works, dealers paying compounded tax, casual traders and the Government departments. We noticed that the revised format of purchase statement prescribed from 11 December 2007 does not provide space for the description of goods without which it is difficult *to* detect excess claim of ITC *prima facie* from that statement.

5.1.2 Mechanism to monitor filing of returns

Under the KVAT Act, most of the dealers are required to file the monthly return while certain dealers are required to file the quarterly returns. Due date for filing the monthly return is 10th/15th of subsequent month and that for the quarterly return is 15th of the month following the quarter. We analysed the process of filing of the returns and noticed the following deficiencies.

5.1.2.1 Deficiency in provisions of the Act/Rules

- The KVAT Act and Rules do not provide for any specific penal clause for belated filing of the returns, though the Act specifies penalty for non-filing of any return and interest for belated payment of tax.
- The CTOs did not maintain any register to show whether the returns/ revised returns alongwith payment particulars have been filed within the due date or whether notice was issued to the defaulting dealers. This was due to the absence of any provisions in the Rules or manual.

5.1.2.2 Deficiencies in compliance with provisions for filing of returns

On analysis of the data on returns received from all DCs, except DC, Alappuzha, we noticed the following deficiencies.

- The AAs did not invoke the penal clause specified in section 67[11] against 11,168 dealers who had not filed the periodical returns during 2005-06 to 2007-08. Consequently, penalty of Rs. 11.17 crore[12] was not realised from the defaulting dealers.
- Dealers with annual output tax liability on intrastate sale of Rs. 25 lakh or more and wholesale dealers, distributors/dealers holding van sale permit were required to file the return of purchase and sale list electronically in addition to hard copy from 1 April 2007.

  We found that only 3,329 dealers had filed the returns in electronic format that year. Despite our specific requests, the DCs did not furnish the number of dealers who had not filed the return in electronic formats during 2007-08. The database showing output tax due from the dealers during 2005-06 to 2007-08 was not available in KVATIS. Hence neither we nor the department could ascertain the number of dealers who had statutory obligation of e-filing of returns.
- The dealers are required to file annual return before 30 April every year. We noticed that 44,251 annual returns had not been filed during the years 2005-06 to 2007-08.
- Every casual trader shall submit to the AA a monthly return alongwith the proof for payment of the tax due. If he stops his occasional transaction during the course of a month, he shall file return within 24 hours of completion of last transaction. We found that many casual traders were evading from registration and were avoiding filing of returns. Besides, out of 487 such dealers who had obtained registration during 2005-06 to 2007-08, 374 dealers had filed returns, of which 325 dealers had paid advance tax.
- Most of the Central/State Government departments, Union Territory, local authorities and autonomous bodies and transporting agencies had not obtained registration and hence were not filing mandatory quarterly return.

We recommend that the department may take action contemplated in the KVAT Act and levy penalty against the dealers for default in submission of returns in time.

5.1.3 Documents to be furnished alongwith the returns

The KVAT Rules specify the records to be submitted alongwith the monthly and annual returns. We found following deficiencies in the documentation process.

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11 Section 67 deals with general penal measures for various offences.

12 At the rate of Rs. 10,000 in each case.

5.1.3.1 Deficiency in provisions

- The list of records to be furnished alongwith the VAT annual return do not include abstract of utilisation of C/F/H forms prescribed under the CST (Registration and Turnover) Rules, 1957, though KGST Rules provided for mandatory submission of the same. These are essential to cross check whether, dealers had accounted for interstate purchases/stock transfer receipt of goods, against which they issue the forms.

In response to our query, seven DCs[13] have admitted that for the years 2005-06 to 2007-08 the dealers concerned had not furnished such details in 4,085 cases. Consequently, the interstate purchase/stock transfer received by these dealers during these years remained unchecked leaving possibility of leakage of revenue as illustrated below.

A dealer in Special Circle, Thiruvananthapuram, issued nine F forms for 2005-06 but did not concede any interstate stock transfer receipt during the year. The AA did not obtain and cross verify the abstract of the forms C/F while scrutinising the returns.

We are of the opinion that the Government may amend the list of records to be furnished with annual returns to include the details of statutory forms issued by the dealers and department may undertake their cross verification at the time of the scrutiny of the returns/ audit assessments.

- Dealers having a total annual turnover not less than Rs. 10 lakh are liable to pay tax. Further, dealers having turnover less than Rs. 50 lakh have an option to pay presumptive tax at 0.5 *per cent* of the taxable turnover. Dealers crossing the above limit are required to pay tax at the prescribed rates. Thus, it is important to monitor the total turnover of the dealers at periodic intervals.

We found that the AAs were ascertaining eligibility for VAT liability (Rs. 10 lakh) and presumptive tax liability (Rs. 50 lakh) solely through the returns and the P&L account submitted by the dealers without ascertaining their correctness with reference to the books of accounts of the dealers. As such there was no scope for detection of dealers crossing the threshold causing loss of revenue as enumerated in paragraph 4.4.1.1.

We recommend that the Government may consider evolving a mechanism where the books of accounts of the presumptive tax paying dealers are verified to detect such dealers crossing the prescribed threshold limit.

[13] Idukki, Kannur, Kottayam, Kozhikode, Malappuram, Palakkad and Thrissur

5.1.3.2 Non-furnishing of enclosures of returns

Our analysis of the data furnished by the DCs of the circles test checked revealed that many of the dealers were not filing of the following documents which are to be filed alongwith annual return or thereafter mandatorily.

Document to be furnished	Period	No of cases for which documents were		Percentage of non-compliance
		due	not filed	
Stock inventory as on 31 March	2005-06 to 2007-08	3,10,886	1,18,459	38.10
Audited statements of accounts and certificate from a Chartered Accountant or Cost Accountant to be filed by the dealers having total turnover exceeding Rs. 40 lakh.	2005-06 to 2007-08	61,120	7,529	12.32
Copy of balance sheet with trading/manufacturing and P&L account by dealers whose total turnover was less than Rs. 40 lakh.	2006-07 and 2007-08	1,74,827	72,384	41.40
Registered dealers having head office situated outside the state have to file Statements of accounts in respect of activities in the State separately along with the consolidated balance sheet and P&L Account if they have not drawn it up separately in the Audit Report.	2006-07 and 2007-08	Not available	Such dealers are mainly operating at Ernakulam and were not filing these statements.	
Reconciliation statements, in case where the details furnished in the annual return vary from those furnished in the monthly returns or P&L Account.	We found that the dealers are not filing it punctually. But only DCs offices Alappuzha and Thrissur admitted non-filing in 84 cases.			

VAT relies on self assessment and AAs are not required to scrutinise the original books of accounts of the dealers in majority of the cases. Hence, the above documents are the only source for detection of short assessment of tax, suppression of turnover, excess availing of ITC etc. However, we found that the department has invoked penal provision such as imposition of penalty upto Rs. 10,000 for non-furnishing of the above enclosures in very few cases.

We recommend that the department may initiate action such as imposition of penalty, suspension of registration etc., against those who fail to furnish prescribed documents and may deny such dealers statutory declaration forms including those under the CST Act.

5.2 Scrutiny and verification of the returns

The assessment relating to the return period is deemed to be complete if the dealer submits the return in the prescribed manner and accompanied by the prescribed documents with correct particulars. Otherwise, the AA has to reject the return after recording the reasons thereof. The AA can complete the assessment to the best of his judgment if the dealer fails to file a fresh return rectifying the defects, or fails to respond to notice for best judgment assessment.

We noticed the following deficiencies in the process of scrutiny and verification of returns.

5.2.1 Deficiency in provisions

5.2.1.1 Short levy due to incorrect acceptance of CST return

The CST Act provides that, 'the general sales tax law' of the State should govern the assessment, re-assessment, collection and enforcement of payment of tax, including any interest or penalty, returns, provisional assessment, advance payment of tax etc . Under the KVAT Act, if the dealer submits the returns in the prescribed manner, assessment shall be deemed to be completed, unless the return is rejected. This is applicable to the CST returns also. Under the CST (Registration and Turnover) Rules, as amended from October 2005, a dealer should furnish declaration in form 'C' or 'F' or the certificate in form E-I or form E-II to the prescribed authority **within three months** after the end of the period to which the declaration or the certificate relates.

We found that though the CST Rule was amended, the State Government did not amend the CST Kerala Rules to incorporate the above changes. The CST Act requires the AAs to levy tax on the interstate sales turnover of goods not covered by valid declaration in form 'C/F' at the rate applicable to the goods under the local sales tax/VAT Act with effect from 1 April 2007. Prior to that date, tax on sale of goods not covered by form 'C/F' was to be assessed at the rate of 10 *per cent* or at the KVAT rate whichever was higher.

During scrutiny of the records in 19 CTOs[14] we noticed that in 184 cases for the years 2005-06 and 2006-07, the AAs did not reject the CST returns submitted, even though the dealers did not furnish declaration in form C/F within the prescribed time. As per the provisions of the CST Act and Rules, the AAs ought to have rejected the incomplete returns and demanded

[14] Special Circles Alappuzha, Ernakulam I, Ernakulam II, Ernakulam III, Kollam, Palakkad, Thiruvananthapuram and Thrissur and Circles Chalakudy, Changanassery I, Irinjalakuda, Kottayam, Kuthiathode, Pala, Pattambi, Mattanchery II, Nedumangad, Thripunithura II, and Thrissur III circle.

tax at the differential rate. This resulted in short levy of tax of Rs. 161.67 crore.

After we pointed out the mistake to the department between July 2008 and May 2009 and reported these to the Government in April 2009, the Government stated (December 2009) that the provision in Central Rule permits submission of declaration even after three months and that under CST (Kerala) Rules, 1957 framed under the CST Act the AAs can make CST assessment for each year by a single order and that dealers can submit declaration in form 'C' and 'F' at any time before completion of assessment. The interpretation is not correct since the State Rules framed based on the CST Act and Rules is void from the date of amendment to Central Act and Rules, *i.e.* October 2005. Besides, the concept of yearly assessment has been dispensed with after introduction of VAT and the KVAT Act provides for submission of returns alongwith all documents which is to be treated as self assessed, of which, only a few cases are to be taken up for detailed audit. Hence, it is mandatory to submit the declaration forms in support of claims of exemption/reduced rate of tax. Also, in case of non-submission of forms if the dealer is prevented by sufficient cause, the AAs has to expressly allow him extension which should be in written orders on the basis of specific requests by the dealers. In the above cases, the AAs clearly missed the point and the contention put forth by the Government is only an after thought after this matter was pointed out by us.

The Government further stated in April 2010 that dealers had since submitted statutory declarations under CST Act in most of the cases and the AAs accepted them and that differential tax was demanded from those who had not filed the declaration. The acceptance of the declaration forms belatedly was irregular as the concerned dealers did not submit the declaration forms in due time and neither sought extension of time in writing within the prescribed timeframe of three months nor did the AAs allow any such extension.

We recommend that the Government may amend the CST (Kerala) Rules immediately in line with the amendments made in the CST Act/ Rules and KVAT Act.

5.2.1.2 Non-prescription of register to watch rejection and follow up of returns

The KVAT Rules do not prescribe any register for monitoring receipt of the returns and as such there was no mechanism to monitor the scrutiny of returns and the circles are not maintaining any register to record rejection of return on scrutiny, issuance of notice for best judgment assessment and their follow up.

5.2.2 Deficiency in scrutiny and verification of the returns

Our analysis of the data (received from all DCs except DC, Ernakulam) on best judgment assessments conducted from 2005-06 to 2007-08 by the AAs based on scrutiny of returns indicated that the AAs issued notice for best judgment in 1,024 cases involving Rs. 20.79 crore. Of these, the dealers remitted tax, interest and penal interest of Rs. 1.30 crore in 468 cases and the AAs resorted to best judgment assessment under section 22(3) for non-response in 391 cases and created additional demand of Rs. 5.98 crore.

We also found that though the number of periodical and annual returns filed by the dealers ran into lakhs, the AAs had resorted to best judgment assessments based on their scrutiny only in a few cases. Since results of scrutiny of 60 annual returns by audit revealed large number of discrepancies, the department may increase the quantum of scrutiny.

5.2.3 Results of scrutiny of returns conducted by audit

We scrutinised the annual returns of some major dealers during the course of review with reference to the monthly returns and form 13A[15] and P&L account to ascertain the compliance with provisions of the KVAT Act with special emphasis on areas where it differed significantly with that of the KGST Act and to verify the effectiveness of departmental scrutiny of the returns of the dealers, whose assessments were deemed as complete. The results of the same are included in the following paragraph and instances of availing of excess ITC in paragraph 6.1.4.

5.2.3.1 Scrutiny of returns of dealers other than work contractors

Provisions of the KGST Act and KVAT Act differed in the following aspects on taxation of discount, used car and medicines.

Item	KGST Act	KVAT Act
Discount	Dealers can exclude all discount allowed as per regular practice in trade while determining taxable turnover.	Act allows to deduct from turnover only discount shown in original invoice, as the purchaser is availing ITC on its basis.
Sale of motor vehicle	Dealer can claim exemption of sales turnover, if taxed at the point of first sale in the State.	If the vehicle is used for a minimum period of fifteen months subsequent to registration (used motor vehicle), rate of tax is four *per cent* up to 23 April 2007 and 0.5 *per cent* thereafter instead of normal rate of 12.5 *per cent* for motor vehicle.

[15] Audited Statement of Accounts to be furnished along with the Audit Certificate.

Item	KGST Act	KVAT Act
Medicine	Sale other than the first point sale in the State is exempted.	If the first seller in the State opted and paid compounded tax based on MRP, then only the second and subsequent sellers can avail exemption on sale of such goods. The former shall not allow any trade discount or incentive in terms of quantity of goods.

We scrutinised 30 annual returns of major dealers in CTO, Special Circle, Thiruvananthapuram, who were allowing discount, transacting in used car and involved in first sale of medicines, to ascertain the compliance of the above provisions. It revealed that, in the following cases, the AAs failed to detect in departmental scrutiny, defects in self assessments which resulted in short/non-levy of tax, interest and penal interest amounting Rs 8.08 crore.

(Rupees in crore)

Sl. No.	Year	Nature of irregularity	Short levy
1.	2005-06 and 2006-07	An assessee availed Rs. 2.23 crore and Rs. 1.40 crore as ITC on discounts and price difference allowed not through invoice but through credit notes. The assessing authority incorrectly exempted the discount allowed through credit note from the sales turnover.	7.16
	The Government confirmed completion of assessment for the year 2005-06 involving short levy of tax, interest and penal interest of Rs 4.71 crore to make good the short levy and stated that assessment for the year 2006-07 was being finalised. We are yet to receive further information on the matter (June 2010).		
2.	2005-06 to 2007-08	During 2005-06 and 2006-07, an assessee did not assess to tax, sales turnover of used vehicle aggregating Rs. 10.97 crore and during 2007-08 he assessed turnover of Rs. 1.01 crore only out of Rs. 13.67 crore.	0.90
	The Government confirmed reassessment of escaped turnover to tax and interest. We are yet to receive further information on recovery of revenue.		
3.	The Supreme Court in the case of M/s Mohammed Ekram Khan and Sons Vs Commissioner of Trade Tax (12 KTR 572) held that warranty charges received for replacing defective parts is sale of goods and is liable to tax.		
	2006-07	A dealer in motor vehicles and spare parts did not assess out put tax on warranty receipts of Rs. 10.42 lakh.	0.02
	The Government confirmed that the assessment had been revised. We are yet to receive further information on recovery of revenue (June 2010).		

5.2.3.2 Scrutiny of returns of work contractors

Our scrutiny of 25 annual returns of contractors of civil works and five annual returns of other type of contractors in CTO (WC), Thiruvananthapuram revealed that in the following cases, the AAs while

conducting scrutiny of the returns did not detect and rectify defects which resulted in short levy of tax, interest and penal interest of Rs. 13.69 crore.

(Rupees in crore)

Sl. No.	Year	Nature of irregularity	Short levy
1.	The KVAT Act provide for levy of compounded tax on whole amount of contract. Tax is assessed on actual contract receipts of the year, i.e., on the whole amount received for the contract during the year including advance from customers.		
	2005-06 to 2007-08	In four cases, work contractors assessed compounded tax on contract receipt aggregating to Rs. 142.77 crore only, but contract receipt on actual basis aggregated to Rs. 211.63 crore. Thus, tax was not levied on turnover of Rs. 68.86 crore.	4.19
	The Department confirmed completion of assessment in two cases and created an additional demand of tax and interest of Rs 25.77 lakh against Rs. 28.30 lakh pointed out by audit and stated that they are finalising assessment in the remaining cases.		
2.	2005-06 to 2006-07	A dealer commenced two new projects during 2005-06 and received advance of Rs. 3.76 crore and Rs. 13.45 crore and assessed tax of Rs. 1.20 lakh and Rs. 4.48 lakh based on transfer value of materials during those years. The dealer assessed compounded tax, for the first project from 2006-07 onwards and the second from 2007-08. The dealer evaded tax by switching over to compounded tax irregularly.	1.17
	The Government stated that department would complete the assessments. We are yet to receive further information.		
3.	Under the KVAT Rules, as it stood prior to 24 April 2007, in relation to works contract, where the transfer of goods is not in the form of goods but in some other form, the value of such goods shall be the value of goods at the time of incorporation into works contract. The value of goods transferred in the execution of works contract shall not be less than the purchase value and shall include all expenses and charges incurred for the conversion of goods into the form in which they are incorporated into the works contract. If the turnover is not ascertainable from the books of accounts, the turnover is to be computed after deducting labour and other charges at various rates as specified in the table under Rule 9(3). For structural contract, Rules specify a deduction of 30 *per cent* of contract receipts towards labour and other charges		
	2005-06 to 2007-08	In two cases, the contractors assessed tax on transfer value of materials which was almost equivalent or even less than the purchase value of goods. Labour and other charges deducted by them constituted 52.40 *per cent* to 77.48 *per cent* of contract receipts. They did not show separately labour charges incurred for conversion of the material into the form in which the goods are incorporated into the work and hence were eligible for deduction of 30 *per cent* only.	4.12

Sl. No.	Year	Nature of irregularity	Short levy
	The department intimated issuance of notice to revise the assessment of one assessee for 2005-06 and 2006 07 and that though they revised assessment of other assessee in May 2009, they kept in abeyance coercive proceedings as per court direction.		
We found that one of the above dealer who had assessed tax on transfer value of goods during 2005-06 and 2006-07 had irregularly switched over to compounded tax at the rate of two *per cent* during 2007-08 for the ongoing projects. As the dealer was registered under CST Act, he is liable to assess tax on his contract receipt of Rs. 21.01 crore at four *per cent.* Assessment of tax at Rs. 49.64 lakh instead of Rs. 84.03 lakh due resulted in short assessment of tax, interest and penal interest of Rs. 48.82 lakh. The Government stated that the contractor had requested for cancellation of registration with effect from 31 March 2007 and that he had remitted registration fee applicable to CST registration by mistake. The reply is not tenable as the CST Act provide that to cancel CST registration with effect from 31 March 2007, the assesee should file application before October 2006. There is no evidence to prove that he had done it.			
4.	2005-06 and 2006-07	Audit assessments of a dealer engaged in the fabrication and cladding of aluminum fittings was finalized in April and July 2008. The AA incorrectly deducted the charges for loading, transporting and unloading and other expenditure incurred for the conversion of goods into the form in which they were incorporated into the works contract, from the taxable turnover.	0.38
	The Government stated that notice had been issued for assessment of escaped turnover. We are yet to receive further information.		
5.	A works contractor who opts to pay compounded tax at two *per cent* is liable to pay purchase tax on purchases made from unregistered dealers. Hence, the dealer is liable to prove that he had either purchased goods, from registered dealers within the State or paid purchase tax.		
	2007-08	A builder who had opted for payment of compounded tax at two *per cent,* enclosed alongwith his returns list of purchases effected from the registered dealers as well as list of purchases from the unregistered dealer, liable to purchase tax. Aggregate of the above purchases was much less than the purchase value of materials disclosed in the P & L account. As the dealers is not registered under the CST Act, he apparently procured stock for the differential value from within the State from sources other than dealers liable to tax. The AA did not take any action to assess purchase tax for the differential amount.	0.55
	The Government stated that the Department completed assessment for the year 2006-07 and notice had been issued for revising assessment of 2007-08. We are yet to receive further information.		

Sl. No.	Year	Nature of irregularity	Short levy
6.	Under the KVAT Act, in the case of transfer of goods involved in the execution of works contract where transfer is in the form of goods, rate of tax applicable is that specified for the goods in the respective schedules. The Act does not provide for deduction of labour and other charges from gross receipts in such category of the works contract.		
	2005-06 to 2007-08	A works contractor engaged in painting and polishing and body fabrication tinkering job, availed deduction of Rs. 1.87 crore towards labour at the rate of 25 *per cent* of the whole amount of works contract receipts. He was not eligible for deduction of labour and other charges as fabrication of the body on the chassis of the motor vehicles is sale of body of the vehicles.	0.12
	The Government confirmed that the assessment has been revised. We are yet to receive further information on recovery of revenue.		
7.	Under the KVAT Act, principal contractor can deduct from his taxable turnover, the amount paid to the sub-contractors registered under the Act for execution of works contract, if he furnishes certificates in form 20 H and copies of agreement with the sub-contractor, in support of the claim for deduction.		
	2005-06 to 2007-08	An assessee who opted for compounded tax on housing projects executed by him availed exemption of Rs. 47.62 crore from the contract receipt, towards payment to sub-contractors without filing certificate in form 20 H and copy of the agreement with the sub-contractors or deducting any tax in the capacity as the awarder.	3.16
	The Government stated that the assessee filed form 20 H for Rs 10.20 crore out of Rs. 10.99 crore for 2005-06 and the department finalised the assessment and demanded tax and interest of Rs. 0.83 lakh for the differential turnover. They also confirmed that they were completing assessment for the remaining years. We noticed that while finalising the assessment department had not taken into account non-deduction of tax at source from sub-contractors and non-filing of agreement with the sub-contractors.		
8.	Under the KVAT Rules, work contractors should file option for compounding in form No. 1 DA, within 30 days from the date on which contract is concluded. A single option may cover one or more works contract. The dealer may also file a single option for all the works undertaken by him during a year. If the AA is satisfied, he shall grant permission in form 4 D.		
	During scrutiny of the records we noticed that most of the contractors did not enter the date of option and year and projects to which the options related etc, in their compounding options filed. The AAs neither acknowledged these options nor granted permission in form 4 D. This would entail scope for the dealers to withdraw the option, if found unfavorable subsequently. For example, in the case of Sl No. 2 of this table, the assessee had filed option for compounding during 2005-06 but he withdrew the option in respect of the project on the ground that AA did not accept it till then.		

We feel that the Department may direct the AAs to conduct thorough scrutiny of the annual returns and accounts submitted by the dealers to unearth evasion of tax. For this, they may consider issuing a check list containing important points to be checked during scrutiny. The Department may also ensure that dealers who file the option forms, invariably fill in the columns relating to date, year and project to which it relates etc., and the AAs promptly issue acknowledgement and permission in form 4D.

5.3 Audit Assessment

As per the KVAT Act, officers not below the rank of DC can be designated to conduct audit visit at the business place of any dealer and to audit any return, books of accounts, any other records or stock statements and goods relating to the business. He may authorise not less than two audit officers not below the rank of an AA to visit the place of business of any dealer and to conduct audit. The Government had designated six DCs[16] to conduct audit assessment. During the review, we noticed the following shortcomings in the process of audit assessments.

5.3.1 Percentage of dealers to be taken up for audit assessment

The percentage of the dealers to be taken up for the audit assessment is not specified in the Act/Rules. The CCT issued a detailed circular in November 2005 specifying the criteria for selection of files for audit assessment, under which previous offences, refund claims, excessive claims of ITC, information on proven or attempted evasion of tax gathered through vehicle checking or other agencies like Central Excise, Income Tax etc., should be the primary criteria for selection of files.

The audit assessment wing is also required to conduct a random scrutiny of five *per cent* each of the returns already scrutinised by the officers of VAT circles.

In the assessments circles selected for test check we found that there was no database regarding the turnover, tax collected, offences committed etc. Consequently, we could not ascertain whether the audit assessment wing followed the prescribed criteria in selection of returns for audit.

The Government stated that month-wise turnover and tax collection is available in KVATIS and that department enter the details of offence booked by intelligence wing in offence module of KVATIS and that concerned circle can view it. The fact remains that the details after introduction of e-filing only are available in the KVATIS and also the data available in the offence module are not exhaustive.

[16] Ernakulam, Kannur, Kottayam, Kozhikode, Palakkad and Thiruvananthapuram.

We feel that the department may take suitable steps to upload the data relating to the period prior to introduction of e-filing to make the database self sufficient.

5.3.2 Time frame for completion of audit assessment

KVAT Act empowers the AAs to reject the return within two years from the last date of the year to which it relates, if return submitted is incorrect or incomplete or ITC or special rebate or refund claimed is not proved. However, the Act does not specify a time frame for completion of the audit assessment even though the design of VAT approved by the EPC stipulated a period of six months time limit for completion of audit assessment.

The Government stated that Section 24 of KVAT Act stipulate time frame for tax audit. However, the provision referred to by the Government allows rejection of return within two years but does not specifically mention about completion of audit assessments.

The pending files in Offices of DC (Audit assessments) were returned to the AAs consequent to the reorganisation of the Audit assessment wing. The Audit assessment wing did not maintain a register for recording details regarding the date of receipt/return of files for audit and date of completion of audit, due to absence of statutory provisions. As relevant data was not available, we could not ascertain whether any inordinate delay had occurred in completion of audit assessments.

We recommend that the Government may specify a time frame for completion of audit assessment and department may prescribe a monitoring system for noting receipt and disposal of files for audit.

5.3.3 Deficiency in performance of audit assessment wing

The details of number of files subjected to audit assessment and the quantum of additional demand generated during the period of review as disclosed by the information made available from the office of the DC (AAs), Thiruvananthapuram having jurisdiction over the districts of Kollam, Pathanamthitta and Thiruvananthapuram are shown in the table below.

	Self assessment		Form 25A	Refund	Audit visit	Desk verification of accounts
	Monthly	Quarterly				
2005-06						
No of returns	1,917	273	757		46	
No. of cases in which irregularities occurred	108	25	237		29	

	Self assessment		Form 25A	Refund	Audit visit	Desk verification of accounts
	Monthly	Quarterly				
Financial impact (Rs in lakh)	85.63	4.51	295.56		12.83	
2006-07						
No of returns	11,695	362		20	297	
No. of cases in which irregularities occurred	996	28		1	297	
Financial impact (Rs in lakh)	49.48	2.55		1.24	104.86	
2007-08						
No of returns	20,669				296	1,628
No. of cases in which irregularities occurred					265	666
Financial impact (Rs in lakh)					182.81	3,523.71
Total for 2005-06 to 2007-08						
No of returns	34,281	635	757	20	639	1,628
No of cases in which irregularities occurred	1,104	53	237	1	591	666
Financial impact (Rupees in lakh)	135.11	7.06	295.56	1.24	300.50	3523.71

It is evident from the above details, that during 2005-06 to 2006-07, the audit assessments mainly remained confined to the scrutiny of returns. The DC (AA) had commenced verification of accounts of the dealers at his office only in 2007-08. The Act actually contemplates visit to dealer's premises and audit of accounts and records of the dealers maintained therein. This was done only in very few cases. However, figures in column 6 reveal that, the wing detected irregularity in 591 out of 639 cases of audit visits. This clearly indicated that such audit visit detected evasion of tax in almost 92.49 *per cent* cases.

We also observed that the AAs refunded the excess input tax remaining unadjusted at the end of the year to the dealers without comprehensive scrutiny as Rules do not prescribe for the same. Though such files required thorough scrutiny by the audit assessment wing, we found that only very few refund files were checked.

We feel that the department may give thrust for verification of returns with the accounts of the dealer. They may fix target to conduct audit assessment at the premises of the dealer and may arrange thorough scrutiny of claim for refund of excess ITC to avoid irregular refund.

Chapter VI
Miscellaneous provisions

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.

Chapter VII
Internal controls and internal audit

CHAPTER VII INTERNAL CONTROLS AND INTERNAL AUDIT

7.1 Internal controls

Internal controls are intended to provide reasonable assurance of orderly, efficient and effective operations, safeguarding resources against irregularities, adhering to laws, regulations and management directives and developing and maintaining reliable data. Effective internal control system both in the manual as well as computerised environments are a pre-requisite for the efficient functioning of any department. We noticed the following deficiencies in the internal control mechanism.

7.1.1 Maintenance of registers in the Commercial Tax Offices

We noticed that the commercial tax circles were not maintaining any records to monitor the filing of the return/revised return, rejection of the return etc., due to lack of mandatory provisions, as commented in paragraphs 3.5 and 5.1.2.1. They are also not recording, issue of notice for best judgment assessments and its follow up. The details of the total turnover, taxable turnover, out put tax, ITC, tax payable/creditable etc., of a dealer can only be retrieved from the assessment records which are not kept systematically in the circles. There is no record similar to the assessment register under the KGST to record such details.

7.1.2 Improper maintenance of files

We found the following deficiencies at special circle, Thiruvananthapuram.

- Monthly/quarterly returns, annual returns, form 13 A and P&L account were not found in any of the files produced to us. The office did not maintain any record to ascertain whether the dealers filed these documents or not. Also, there was no record to show whether a dealer had filed any revised return.
- Though we called for all the files pertaining to refunds made during the review period, the office could make available only three files. Of these, form 13 A and P&L account were available only in one of the files.

The above deficiencies point towards lack of a system for recording the receipt of the return from a dealer and systematic maintenance of the return and connected enclosures.

We recommend that the Government may consider issuing early direction for proper maintenance of basic records in the circles.

7.1.3 Provisions for compilation of reports/returns received from circles and submission to the Commissioner for monitoring

As per the circular of the CCT in September 2005, the DC in-charge of the district and the DC (AA) is required to submit to the CCT monthly diary of performance of each officer under them before 10th of every month. The diary of the DC is to include the details regarding the issue of registrations to TIN, PIN, compounded tax and casual dealers, details of collection under VAT, demand, collection and balance under VAT containing both old and current/stages of arrears, details of return scrutiny etc. The diary submitted by the DC (AA) is to show the details of audit of monthly/ quarterly return, audit of refund cases, audit visit and internal audit of KGST files etc.

We found that there was no system in the commissionerate for consolidation of the returns received from the field offices. Also, whenever we sought any information, they forwarded our demand to the DCs who in turn had to collect it from their subordinate officers. As such, it can be inferred that the monthly diaries were not serving the intended purpose of monitoring the progress achieved in the activities assigned to each wing. However, at present the performance of the AAs are monitored daily by DC (A&I), DC (IA) etc., and the consolidated reports are available in KVATIS software. But, the database does not cover the information relating to the period prior to introduction of e-filing which the Government needs to look into. Also, we are yet to verify the correctness of the MIS reports generated from the KVATIS.

7.2 Internal audit

Internal audit is one of the most vital tools of the internal control mechanism and functions as the 'eyes' and 'ears' of the management and evaluates the efficiency and effectiveness of the mechanism. It also independently appraises whether the activities of the organisation/ department are being conducted efficiently and effectively.

7.2.1 Existence of internal audit

As per the circulars of CCT in September and November 2005, the department had dispensed with the internal audit wing. However, they have entrusted audit of assessments completed under the KGST, KVAT and CST Act to the audit assessment wing. The CCT also directed that a group of CTOs headed by the AC (AA) should audit each and every file with reference to connected registers. The DC (AA) should inspect the sub-offices of all the wings of the department including the check post and conduct the concurrent audit of the assessments.

We are of the opinion that an internal audit wing is required to inspect the entire departmental activities including the assessments conducted by various officers. Hence, by dispensing the internal audit wing, the department has restricted the scope to detect anomalies/irregularities in the department some of which had been pointed out in this review.

We recommend that the Department may ensure periodic internal audit of the entire departmental activities to reduce the loopholes and lacunae in the system and for rectifying them.

The Government stated that at present Audit Wing of the department is strengthened by four ACs and five CTOs under the supervision of DC (Internal Audit).

Chapter VIII
Conclusion and summary of recommendations

CHAPTER VIII CONCLUSION AND SUMMARY OF RECOMMENDATIONS

8.1 Conclusion

The department had made adequate preparations for switching over to VAT. Achievement of the department in computerising the data of existing dealers and introduction of e-filing is worth mentioning. We are happy to mention that Kerala is the pioneer in prescribing mandatory e-filing by all classes of dealers from January 2009. This is indeed a significant achievement which will enable the department to exercise better control and monitoring on the dealers. Also, we appreciate department's move to provide us the access to its database which had made things easy for us.

However, we found the following deficiencies which the Government and the department need to address.

Even after four years of implementation of VAT in the State, the VAT manual has not been finalised due to which there is no reference point for the departmental officers for healthy practices. We noticed instances of non-registration of those liable to get registered and to file returns and cases of non-filing of mandatory documents required for effective scrutiny of the returns. The department has not installed a system for periodic verification of the books of accounts of the dealers paying presumptive tax. Scrutiny of the returns was not effective as revealed from the quantum of non/short levy detected from the sample of assessment files scrutinised by us during this review. Audit assessment done was not as contemplated in the Act and we found that this process is yet to be streamlined. Certain deviations from the VAT design specified by the EPC resulted in loss of revenue and unintended benefit to the dealers. The department did not take timely action to amend the CST (Kerala) Rules in view of the amendments in the CST Act. Though the dealers did not submit the declaration forms within the time specified in the CST Act, the AAs did not finalise the CST assessments as prescribed in the Act. The department has not instituted a system of cross verification with the records of other dealers/IT, CE department/TINXSYS while scrutinising returns/audit assessments. Failure to detect and rectify apparent misclassification of remittances resulted in short demand of VAT compensation from the Central Government. Internal controls in the department needed attention as we found improper maintenance of files, non-compilation of data received at the commissionerate from the field units etc. Due to non-conducting of internal audit, the department remained unaware of the loopholes and the system and compliance deficiencies, some of which have been pointed out in this review.

8.2 Summary of recommendations

The Government/department may consider implementing the recommendations noted under the respective paragraphs in this review with special emphasis on the following to rectify the deficiencies.

The Government may

- Introduce at the earliest a comprehensive manual of VAT specifying procedures for administration of Act and Rule;
- Make provisions in the KVAT Rules for mandatory verification of records of Income Tax/Central Excise departments and TINXSYS while conducting audit assessments/assessment of escaped turnover;
- Consider amendment of Act/Rules to make mandatory deposit of percentage of tax, interest and penalty in dispute, before entertaining appeal cases to ensure registration of genuine appeal cases only and lessen the scope of evasion/ run away cases.
- Amend the Act/Rules to fix a minimum penalty for each and every offence based on its magnitude to avoid unfettered discretion of the assessing officer. There must be specific distinction between amount of penalty leviable for the first and subsequent offences.

The Department may

- effectively monitor disposal of pending assessments and collection of arrears of pre-VAT period;
- evolve a foolproof mechanism for detection of unregistered dealers and bringing them under the tax net. It is desirable to prescribe a system for monitoring surveys/raids and to fix specific targets to the DCs/ Intelligence Wing;
- publish in departmental website details of cancelled and suspended registrations to verify whether dealers avail ITC on goods purchased from such dealers;
- create a database for uploading the stock position of dealers for future reference;
- include an Audit Module in the KVATIS software;
- enforce strict compliance of the provisions regarding filing of the returns and prescribe specific penal provisions for delayed filing of returns to arrest cases of delayed/non-filing of returns;

- direct the AAs to conduct thorough scrutiny of the returns especially with reference to the figures of the enclosures to the audit certificate/P&L account submitted by the dealers;
- take actions such as imposition of penalty, suspension of registration etc, against those who fail to furnish the prescribed documents alongwith the returns, without it being limited to levy of penalty alone;
- enforce compliance of time limit prescribed in the Act for disposal of the appeal cases;
- give direction to the AAs for maintenance of basic records in circles;
- store details of monthly diary received from circles/check posts in computer so that they can consolidate and retrieve it, whenever required and thus avoid wastage of time and manpower in collecting the same data again; and
- ensure that internal audit is strengthened.

Thiruvananthapuram,
The 8 SEP 2010

(K S SUBRAMANIAN)
Accountant General (WF&RA)
Kerala

Countersigned

New Delhi,
The 10 SEP 2010

(VINOD RAI)
Comptroller and Auditor General of India

Annexures

Annexure – I

Major variations in KGST Act and KVAT Act

(Reference Paragraph 1.1)

	KGST Act	KVAT Act
Registration	Specified quantum of turnover for registration of general class of dealers – Rs. 1 lakh.	Specified quantum of turnover for registration of general class of dealers – Rs. 5 lakh.
	Eight digit registration number	Eleven digit registration number. Presumptive Tax payer's Identification Number (PIN) for those dealers who have opted for payment of presumptive tax and Tax payers Identification Number (TIN) for other dealers.
Rate of tax	26 rates ranging from one to 90 *per cent*	Five rates-Besides VAT specific rates, Act specifies 0.5 *per cent* and 20 *per cent* tax for used vehicle and aerated soft drinks excluding soda
Schedules	Five schedules specifying commodity, points of levy and rate of tax. First schedule –single point taxable goods other than declared goods. Second schedule- single point taxable declared goods, third schedule- exempted goods. Fourth schedule- rate of tax on different category of works contract. Fifth schedule- two point taxable goods	Four schedules and a Notified list of Goods taxable at 12.5 *per cent*. First, second and third schedules lists exempted, one *per cent* taxable and four *per cent* taxable commodities respectively. The fourth schedule lists goods under the purview of KGST Act.
Point of levy of tax	Predominantly single point, at the point of first sale. Some commodities are taxable at the point of first or last purchase and some others at the point of first as well as last sale	Provide for levy of tax at appropriate rate at every point of sale (output tax)
Input tax credit	No set off of tax paid on purchase of goods.	Credit of tax paid on the purchase for sale and manufacture from the output tax payable on sale except for medicines and drugs on which tax on MRP is leviable and on purchases by and from presumptive tax or compounded tax dealers

Tax liability	Specified quantum of turnover for general class of dealers – Rs. 2 lakh.	Specified quantum of turnover for general class of dealers – Rs. 10 lakh. Dealers below this limit can also opt to pay tax.
Presumptive tax	No such class of dealers	Dealers who are not importers or first sellers and whose total turnover does not exceed Rs. 50 lakh have the option to pay presumptive tax at the rate of 0.5 *per cent* of the taxable turnover.
Compounded tax	Dealers of gold or silver ornaments or wares, metal crusher units and work contractors can opt to pay compounded tax in lieu of normal tax	Besides, work contractors and metal crusher units, compounding facility is extended to dealers in cooked food other than bar attached hotel of above three star or club or heritage hotel, dealer who transfers right to use video cassette and importer or manufacturer of medicine and drugs. Dealers of ornaments or wares or articles of gold or silver and platinum group of metals can also opt for compounded tax from 1 July 2006
Assessment	*Cent percent* assessment	Assessment is deemed to be complete if self assessment return of dealer is found to be in order. Detailed scrutiny conducted in cases selected by audit assessment wing.
Concessions and Exemption	Act empowered Government to grant exemption and reduction from rate prescribed in the schedule even to specified class of dealers through notifications	Act does not empower Government to grant exemption and reduction to specified class of dealers through notifications but government can amend schedule.
Other taxes	Act provided for levy of 15 *per cent* of sales tax as additional sales tax (AST)	State dispensed with AST but introduced cess and surcharge from April 2008, subject to conditions.
Sales statement	Dealers need not furnish statement of sales along with return.	Dealers should file details of sales made to registered dealers along with periodical return

Annexure – II

Deviation from VAT design approved by the EPC

(Reference Paragraph 6.9.1)

Sl No	Commodity	Vat Rate	
		Approved by EPC (original)	Adopted by the State
1.	Rubberised coir products other than fiber foam mattress	12.5	0
2.	Accessories of fishnet	12.5	0
3.	Smokeless country oven	12.5	0
4.	Candle	4	0
5.	Clay used for manufacture of bricks and tiles	4	0
6.	Handmade soap, squashes and pickles sold under registered kudumbasree brand	4	0
7.	Printed forms of Court, Electoral Rolls, and PSC applications	4	0
8.	Bamboo, Bamboo ply, cane and its products	4	0
9.	Minor forest produce collected from tribals by Kerala State Scheduled Castes/Scheduled Tribes Development Co-operative Federation Ltd	4	0
10.	Products of Rehabilitation Centre under the Institute of Mental Health and Neuro Sciences (IMHANS), Kozhikode	4	0
11.	Coconut oil (from 1.5.2007)	4	0
12.	Copra (from 1.6.2007)	4	0
13.	Embroidery or zari articles that is to say, imi zari, kasab, saima dabka, chumki, gota sitara, naqsi, kora, glass bead, badia (from 1.7.2006)	4	0
14.	Products manufactured and sold by kudumbasree units under brand name as notified by Government from time to time (from 1.4.2007)	4	0
15.	Recharge coupon	4	0

Sl No	Commodity	Vat Rate	
		Approved by EPC (original)	Adopted by the State
16.	Prasadam and sale of goods received as offering from devotees by the Devaswom Board	4	0
17.	Products such as chalk, umbrella and books (binding) manufactured by Kerala Federation of the Blind at the point of sale by them	4	0
18.	Paper bags (from 1.4.2008)	4	0
19.	Food grains (rice & wheat, excluding products)	4	1
20.	Human hair	12.5	4
21.	Fiber foam mattress	12.5	4
22.	Intermediates like bars, rods profiles structures etc., of various metals	12.5	4
23.	Bakery products, confectioneries and fruit products	12.5	4
24.	Bleaching powder of all varieties and descriptions	12.5	4
25.	Desiccated coconut and other coconut products	12.5	4
26.	Dry fruits like figs etc	12.5	4
27.	Handmade soaps at the point of sale by dealers whose annual turnover does not exceed Rs. 2 crore	12.5	4
28.	Tortoise Shell, Whale Bone, Whale Bond Hair, Horns, Antlers, Hooves, Nails, Claws and beaks, unworked or simply prepared but not cut to shape, powder and waste of these products	12.5	4
29.	Jute cum polypropylene coverings	12.5	4
30.	Lemon Grass Oil, Palmrosa Oil, Vetiver Oil, Citronella Oil, Cinnamon Oil, Clove Leaf Oil	12.5	4
31.	Locks, Padlocks and keys (all kinds)	12.5	4