# Structure and Administration of VAT in Canada – Lessons for India

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## I. INTRODUCTION

Canada is one of those federal countries[2] that have implemented a comprehensive VAT at the central (federal) level. It is known as goods and services tax (GST), which replaced the prevailing manufacturers sales tax on 1 January 1991.

At the sub-national (provincial) level, however, there are different forms of sales taxes. To harmonize these taxes at the federal and state levels, serious efforts have been made.

In view of the similarities in the federal structure and also in the efforts to integrate and harmonize commodity tax systems in Canada and in other federal countries such as India, this paper analyses the structure of GST and provincial sales taxes as well as state VAT in Canada. It also reviews the system of governance of GST. Finally, it draws lessons for the introduction of a comprehensive VAT in the Indian federation.

The paper is organized as follows: Section II. reviews the weaknesses of the (then) prevailing federal sales tax, analyses the evolution of GST and presents the structure of GST. Section III. analyses the system of sales tax/VAT in the provinces, including rates, base and exemptions. Section IV. deals with the efforts made by the federal government to harmonize federal and provincial sales tax/VAT. Section V. describes the system of governance of GST. It includes reporting and accounting obligations of traders, procedures for the governance and Management Information System (or MIS) for the administration of GST. Finally, section VI. presents lessons for India in providing a rational structure and management of VAT, followed by concluding remarks in section VII.

## II. STRUCTURE OF GST

Prior to the introduction of GST, Canada had a federal sales tax (FST) at the manufacturing level. It was levied by the federal government and was in the nature of a turnover tax. Initially it was levied at the rate of 1% on all sales except at the retail level. This was converted into a single-stage levy in 1924 and was collected at the manufacturing level only. Over the years, the rate of tax was raised to 13.5 % on most goods. It emerged as a major source of revenue for the federal government. In 1990 it contributed about one sixth of the total federal tax revenue.

FST was criticized right from its inception. First, it had a narrow base covering only one-third of the total consumer expenditure.[3] Second, the structure of tax was complex with artificial distinctions drawn between commodities and services causing frequent disputes on the basis of law. Third, the FST resulted in cascading as it was taxing many business inputs. Also, the FST caused distortions due to exclusion of trading margins of wholesalers and retailers and through the practice of splitting the functions of advertising and marketing from physical manufacturing operations. It favoured imports in that it was levied on the cost price of imports excluding mark up and distribution costs. Finally, there were problems in the valuation of proprietary rights, branded goods, sole distributorships and sale by manufacturers to related marketing agencies.

Efforts have been made from time to time to remove these deficiencies. Some of the reforms were responsible for the introduction of the concept of "notional values" and of "marginal manufacturer".

Proposals were also put forth to shift the point of levy from manufacturer to wholesale level and to promulgate rules whereby a person selling goods produced by a manufacturer to whom he is related could be deemed to be the manufacturer of goods. There were also proposals to delimit deduction for marketing and distribution costs to what could reasonably be attributed to sale of manufactured goods.

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2. It has two tiers of government: federal and provincial. There are ten autonomous provinces and three territories under the federal government. These are Northwest Territories, Nunavut, and Yukon Territory.
3. The FST applied to scarcely one-third of all goods and services. About half of the FST revenue came from taxes on inputs. For comprehensive treatment of FST, see John Whalley and Deborah Fretz, *The Economics of the Goods and Services Tax*, Canadian Tax Foundation, Toronto, 1990; Richard M. Bird, "Where Do We Go From Here? Alternatives to the GST", *KPMG*, Toronto, April 1994, *Sales Tax Reform*, Ministry of Finance, Ottawa, Canada, 1987 and *Replacing The GST: Options for Canada* (Ninth Report), House of Commons Standing Finance Committee, Canada, 1994.

## A. Federal VAT

In view of the continuing complexities of FST, it was replaced by GST with effect from 1 January 1991, which covered almost all consumption goods and services at all stages of production and distribution processes. While it excludes investment goods, input tax credit is allowed for all non-labour inputs in the course of business. The tax is levied at the rate of 7% on sale price. Notwithstanding its comprehensive scope, GST provides for a few exemptions and zero rating of goods and services. It also provides for tax rebate and low income tax relief.

*Exemption*: While most goods and services are taxable, some exemptions are provided for economic, administrative and political reasons. Exempt items include most goods and services supplied by governments, sales made by small traders with an annual taxable turnover of less than CAD 30,000 and occasional sales by private individuals (such as private sales of used cars). The exemption also applies to residential rents (other than temporary accommodation), most health and dental services, domestic financial services (such as interest on loans, charges for accounts, credit card fees and commission on transactions in stocks or other securities), day care services, and educational services.[4] Resales of old houses are also exempt.[5] In this respect, it is important to note that exemptions are really not important under VAT unless they are at the final stage. Exemption at an earlier stage does not allow input tax credit on sales at later stages and the tax on inputs is borne by the exempted commodity.

*Zero rate*: In addition to the exemptions on the above mentioned items, there are some zero rated items, such as exports and international flights. Most agricultural and fish products, basic groceries[6] (excluding snack foods, non-food beverages, take-away and restaurant meals), prescription drugs and medical devices also fall within this category. All purchases made by provincial and territory governments are zero rated either through mutual agreement or through treaties between the provincial and territorial governments. Sales by farmers are zero rated. Individuals and organizations having diplomatic immunity are also eligible to buy goods at the zero rate. Purchases by visitors (for taking goods out of Canada) are also zero rated, provided the amount paid exceeds a certain threshold. Visitors can claim a refund of the tax paid on accommodation.[7]

*Tax rebate*: Institutions such as municipalities, academic institutions (including universities), schools and hospitals, generally referred to as MASH sector, that do not engage in sales but provide services, pay GST on their purchases. Such institutions receive a partial rebate on taxes paid by them.[8] This amounts to a partial zero rating, as the supplier may claim a rebate for a portion of the taxes paid on purchases.[9]

## III. PROVINCIAL SALES TAXES

At the sub-national level, all provinces, except Alberta, levy sales tax.[10] There are three different models among the provinces levying sales tax: Quebec levies a VAT (known as Quebec Sales Tax, QST); three of the provinces (i.e Newfoundland, Nova Scotia, and New Burnswick) levy a harmonized sales tax (HST), a combination of GST and state VAT,[11] and the rest of the provinces levy a retail sales tax (RST).

The scope of QST as well as HST is comprehensive covering most goods and services. However, RST is basically levied on goods only with some exceptions. Thus, the provinces which impose RST tax a lot of inputs and a few services. On the contrary, QST as well as HST are levied on services but not on investment. Most provinces exempt a few specified consumer and producers goods.[12] In general, the RST of Canadian provinces resembles the RST levied in the USA. In both systems, there are two kinds of exemptions: consumer products and goods for resale. The first exemption attempts to mitigate the distributional burden, the second is an integral part of any RST based on suspension technique.[13]

Exemptions under RST vary from one province to another. Prince Edward Island, Manitoba, Saskatchewan and British Columbia, for example, exempt non-prescription drugs and medical supplies. Some of the provinces exempt, in a limited way, adult clothing, footwear, magazines, periodicals, and student supplies. The treatment of producers goods and machinery used in production processes also varies from province to province. In general, while all provinces exempt farm equipment, some provinces have a limited exemption for specified machinery and equipment. Many provinces exempt building materials purchased for public buildings such as hospitals and schools. Exemption is granted for thermal insulation material and energy conservation devices in most provinces. Also, goods taxed under separate statute (such as excise duties) are exempt in most provinces. These include tobacco products and alcoholic beverages. All provinces, except British Columbia, provide a specific exemption for certain purchases by the MASH sector. All provinces except Saskatchewan levy tax on prepared meals and set a minimum on taxable meals, ranging from CAD 2 in Prince Edward Island to CAD 7 in British Columbia.[14]

4. The exemption applies to the basic services. Certain specific services, however, remain taxable. The exemption of health services, for example, does not include cosmetic surgery or a diamond denture.
5. Sales of new residential premises are fully or partially taxable. There is a tax at the rate of 7% on new residences of more than CAD 450.000. Residences of less than CAD 350,000 benefit from a rebate of 2.5%. There is a phasing out of rebate for houses of between CAD 350.000 and CAD 450.000.
6. A purchase of six or more doughnuts in a grocery store is treated as basic food and is hence zero rated. Purchases of less than six doughnuts in a restaurant are treated as snacks, and therefore, taxable.
7. No refund is given for goods consumed in Canada (viz. restaurant meals, gasoline, alcoholic beverages, tobacco) and services purchased in Canada.
8. The rebate is 57.14% for municipalities, 66% for universities and public colleges, 68% for schools, 83% for public hospitals, and 50% for government registered charities and non-profit organizations.
9. To this effect, a specific rebate application must be filed with the Canada Customs and Revenue Agency (CCRA) that verifies the amount and sends the rebate amount directly to them. For details, see Canada (1994), see footnote 3, p. 15.
10. Since Alberta has considerable resources from the sale of petroleum, it does not levy a provincial sales tax. However, GST (being a federal tax) is the only sales tax levied in this province.
11. For details on HST, see *Harmonised Sales Tax*, Technical Paper, Department of Finance, Ottawa, Canada, 1996. Richard M. Bird and Pierre-Pascal Gendren, Dual VATs and Cross Border Trade: Two Problems One Solution?, *International Tax and Public Finance*, 1998, 5, pp. 429-442 and Richard M. Bird, "CVAT, VIVAT and Dual VAT: Vertical 'Sharing' and Inter-State Trade" (mimeo), (Revised) 2000.
12. Among the consumer goods, exempt items include food, medications, medical appliances, books, children clothing, farm products, seeds and crops, livestock, and fertilizers. Goods purchased for resale are also exempt.
13. Unlike the VAT regime under which tax is collected at each point of transaction, collection under retail sales tax is suspended until the last sale to a consumer.





Most services are exempt under RST. However, over the years, many provinces have attempted to bring services, such as car repairs, hotel/motel accommodation within the scope of RST. Insurance premiums, for example, are taxable in Newfoundland with different rates for different schemes. Telephone and other communication services also fall within the category of taxable services. Similarly, computer software, and labour services are taxable in most provinces. Many provinces provide for a separate tax on specified goods and services, such as, alcoholic beverages, restaurant meals and telephone services.

The standard rates of RST/VAT in force in 2001 in the different provinces are as follows:

| | | |
|---|---|---|
| Prince Edward Island | 10% | PST |
| Ontario | 8% | PST |
| Manitoba | 7% | PST |
| British Columbia | 7% | PST |
| Saskatchewan | 6% | PST |
| Quebec | 7.5% | VAT |
| Newfoundland | 8% | HST (VAT) |
| Nova Scotia | 8% | HST (VAT) |
| New Brunswick | 8% | HST (VAT) |

The standard rates are applicable to most commodities. Special rates apply to alcoholic beverages. For example, the rate is 25% in Prince Edward Island, 12% in Ontario and Manitoba, 10% in British Columbia and 8% in Quebec. In some of the provinces, this tax is levied over and above the normal RST/VAT. In addition, most provinces have liquor sales monopolies which are also taxing agencies.

## IV. EFFORTS AT HARMONIZATION

The federal government has attempted to harmonize both the federal and provincial taxes. After more than six years of discussion, the federal government has entered into an agreement in 1996 with three small eastern provinces (viz. Newfoundland, Nova Scotia and New Brunswick) to introduce a harmonized sales tax (HST), i.e. a comprehensive VAT.

Effective from 1 April 1997, HST has been levied in these provinces. The HST covers the same base of goods and services as GST.[15] The new combined rate of HST of 15% (i.e. 7% federal component and 8% provincial component) was significantly lower than the previous combined rate of 19.84% in Newfoundland and 18.77% in the other two provinces. Exports to other provinces are zero rated. However, unlike QST, the GST registrants in other provinces selling to anyone in the HST provinces must charge HST on such sales. HST registrants making such purchases may then claim credit for this tax. Final consumers or exempt purchasers would, of course, bear the full tax whether they buy from in-province or out-of-province sellers. However, as with GST, certain purchasers such as the MASH sector and financial institutions are entitled to partial input tax credits. Also, as with GST, the place of supply is determined according to specific rules that bring many cross-border services into the tax net.

Businesses registered for GST are automatically registered for HST. They must collect HST on all taxable sales at the rate of 15% and remit the tax to the federal government. Out of this, revenue collected for the participating province (through 8% tax) is allocated by the federal government to the concerned province.

GST (as well as HST) levied by the federal government and RST (or VAT) levied by provincial governments affect the same consumers. However, there are differences in their respective collection procedures. GST, HST and VAT are collected from all the traders registered with the tax department but RST is collected only from those dealers who sell directly to final consumers.

While HST harmonizes the federal and provincial sales taxes, it is important to note that HST is legislated and administered by the federal government. The provinces receive their (8%) share, which is calculated on the basis of a formula based mainly on consumption,[16] although some other variables are also taken into consideration. In addition, the provinces receive a grant of CAD 961 million, payable over a period of four years, as adjustment assistance to compensate for the loss in revenue due to the reduction in the tax rate.[17] In this respect, it is important to note that the provinces imposing HST have no discretion

14. In all provinces liquor is included in the minimum taxable supplies for meals.
15. For further discussion on HST, see Jack M. Mintz, Thomas A. Wilson and Pierre-Pascal Gendron, "Canada's GST: Sales Tax Harmonisation is the Key to Simplification", *Tax Notes International*, Tax Analysts, 1994, and P.P. Gendron, J. Mintz and T. Wilson, "VAT Harmonization in Canada: Recent Developments and the Need for Flexibility, *International VAT Monitor*, 1996, 7, pp. 332-342.
16. Statistics Canada (the federal statistical agency) collects the consumption data. However, as pointed out in Bird and Gendron (1998, see footnote 11), one may question whether such estimates could adequately capture all the shifts in economic situation in all the provinces.
17. In addition, HST has tied the hand of the federal government since it cannot change either the base or the rate of the tax without the unanimous agreement of these provinces. See, Bird and Gendron (1998, see footnote 11).

over the base or the rate of the tax. In effect, it is like a revenue sharing system where the revenues are allocated by the province of origin. In view of this, the other provinces have not considered this favourably, although special adjustment assistance such as the one granted to HST provinces has been extended to three additional provinces.[18] For this reason, it is unlikely that bigger provinces would ever join HST since they would have to give up discretion over their sales tax policy.

Quebec levies QST, a comprehensive VAT. When introduced in 1991, it had some differences in the provisions, as compared to GST.[19] These differences were related to the taxable base as well as to the system of input credit. Over the years, however, most of the differences have been eliminated.[20] Unlike HST, which is collected by the federal government, Quebec collects GST as well as QST and remits the yield of GST to the federal government after deducting the charges for collection.[21]

Four of the provinces, viz. Ontario, Manitoba, British Columbia, and Prince Edward Island levy provincial RST. Ontario, Manitoba and British Columbia impose RST on the price exclusive of GST and one small province (i.e. Prince Edward Island) levies RST on a GST exclusive base.

As a federal tax, GST is levied on inter-state sales. However, none of the provinces levy tax on inter-state sales, because out-of-state sales are not sales at the retail stage. Their retail sales tax/VAT jurisdiction is confined to sales within their own borders. For example, if an Ontario vendor delivers products to a vendor in Quebec, he would not charge Ontario tax. However, if a Quebec buyer actually takes delivery of the goods in Ontario, he must pay the Ontario tax. Thus, a sale delivered outside the province is free of provincial sales tax/VAT of the province of origin.

In addition, each province has laws that require purchasers to self assess the tax when they purchase anything from a place outside the province. Although provinces rely on voluntary self-assessment by purchasers, this is buttressed by exchange of information between provinces based on mutual agreement.

Canada thus offers a variety of interesting situations:
(1) separate federal and provincial VATs administered provincially;
(2) joint federal and provincial VATs administered federally; and
(3) provincial RSTs administered separately.[22]

## V. GOVERNANCE OF GST

Management of GST requires the following declarative and accounting obligations.

### A. Declarative obligations

#### 1. Registration of traders

The first important declarative obligation relates to the registration of traders. It is the kingpin of the management of VAT. It ensures verification of all the traders who have submitted returns and paid the tax. Accordingly, every trader whose turnover is more than CAD 30,000 p.a. must register for GST with the Canadian Customs and Revenue Agency (CCRA). Traders whose turnover is less than this threshold amount have the option to voluntarily register in order to claim refunds from the government of the GST paid on goods and services used for exports or to be able to pass on input tax to their customers.

Registration ensures that all taxpayers file the necessary information and remit the appropriate amount of GST in accordance with the legal provisions. While applying for registration, the trader provides the department with information on GST/HST accounts, payroll deductions, import/export accounts and corporate income tax accounts etc. in a prescribed form. The general information relates to the identification of the business, its ownership and the major commercial activity. The department, in turn, sends out a registration kit including requisite information and a registration application form.

On receiving the application for registration from the trader, the department allocates him a unique business number (BN) which could be used for GST, income, tax, payroll tax, and all other taxes. Some of the provincial governments also use the same BN.

The BN consists of a root number (9 digits), a program identifier (2 characters) and a reference number (4 digits). The root number is the same as the current GST number (except in the case of a divisional business entity).[23] The reference number uniquely identifies the division.[24]

#### 2. Submission of return and payment of tax

All registered traders are required to submit a periodical return. In view of the concentration of traders in the low sales bracket, three types of filing periods are followed based on the size of operations, determined according to gross sales volume.

18. These provinces are Prince Edward Island. Manitoba and Saskatchewan.
19. See Mintz, Wilson and Gendron (1994. see footnote 15).
20. The differences in the taxable base are adjusted. For example, books are taxable under GST but are exempt under the QST. This is administered by first applying combined QST-GST to sale of books but simultaneously providing a rebate of the QST on the sale to final consumers. thus, in effect , zero rating books only for QST. See Bird and Gendron (1998, see footnote 11).
21. The federal government compensates the Quebec government for administrative costs on an agreed per registrant basis. (Bird and Gendron. 1998, see footnote 11).
22. For details, see Bird (2000. footnote 11).
23. In this case the divisions have the same number as the parent.
24. That is, the parent will be 0001. the first division 0002. and so on.





- Firstly, traders whose total turnover is more than CAD 30,000 but is less than, or equal to, CAD 500,000 pay tax on a quarterly basis and submit annual returns at the end of the fiscal year. Such traders, as shown in Table 1, represent 92% of the total number of traders.
- Secondly, traders whose turnover is more than CAD 500,000 and less than CAD 6 million submit a quarterly return and pay tax simultaneously. These traders represent 7% of the total number of traders (see Table 1).
- Finally, traders whose total business turnover is more than CAD 6 million pay GST on a monthly basis and simultaneously submit returns. Such traders represent 1% of the total number of traders in the country (Table 1). The distribution of traders in different sales turnover brackets indicates that large traders having a turnover above CAD 200.000 (representing 15% of all traders) pay over 80% of the total GST revenue. In order to reduce the workload of the VAT authorities, the rules have been modified to call for annual returns from more traders. Thus, as shown in Table 2, there has been a considerable increase in the number of traders required to submit an annual return. This was a deliberate policy decision to reduce the number of returns from small traders. As these traders do not provide much revenue to the VAT authorities, the idea was to concentrate on "risk analysis" and save time from the routine work for these traders.

Table 1: Number of registered traders according to sales distribution

| Sales distribution (annual sales CAD 000s) | Registrants (per cent to total) |
|---|---|
| under 30 | 26 |
| 31 – 200 | 59 |
| 201 – 500 | 7 |
| 501 – 2000 | 5 |
| 2001 – 6000 | 2 |
| above 6000 | 1 |

The return could be submitted either at a bank or mailed with the requisite cheque to the collection office. However, to enable traders to submit returns on time, the VAT authorities generate a return for each dealer and send the same to the taxpayer some weeks before the due date of submission.

Table 2: Total number of traders falling into different filing frequency

| Filing frequency | Percentage of total registered traders 1999 | 1994 |
|---|---|---|
| monthly | 4 | 4 |
| quarterly | 60 | 87 |
| annual-quarterly remittances* | 7 | 2 |
| annual | 29 | 7 |

* The filing is annual but remittances are quarterly.

The regulations also provide for submission of returns and payment of tax electronically, provided that traders meet the requirements set out in the law. Originally, traders were allowed to submit returns electronically if they had obtained prior permission in writing from the VAT authorities. Recently, the regulations have been liberalized to allow submission of returns electronically without the need for such permission.

### B. Accounting obligations

Although GST administration does not prescribe any specified format for maintaining accounts, the accounting obligations of traders require that they maintain sufficient details to show their purchases and turnover to enable the VAT authorities to verify input credit and VAT liability.

For small traders whose turnover is less than CAD 500,000 p.a., the VAT authorities permits a "quick method" for estimating VAT liability. Such traders estimate their tax liability on the basis of their turnover. They apply a fixed percentage to the total sales to arrive at their tax liability. The fixed percentage varies according to the nature of supplies made. The different percentages for the traders opting for the "quick method" are as follows:

| | |
|---|---|
| vendors of goods | 3% |
| vendors of services | 5% |
| grocery vendors (50% or more grocery sales) | 1% |
| grocery vendors (25 to 50% grocery sales) | 1.75% |

Traders following the "quick method" are allowed to maintain simplified accounts. However, it is necessary that, once they opt for such a method, they must continue to follow the same method for at least one year.

While this method is not very popular among traders, it is particularly followed by convenience stores, small traders hiring one or two persons, and businesses dealing in mixed inventory.

### C. Processing of returns

This is the central component of the system where all accounting information is uploaded and posted. This centre processes all the documents relating to registration, submission of returns, payment of tax and claims for input credit.

To enable the processing centre to carry out its operations efficiently, all the documents are first put into batches with a unique batch header (control code). Batches with payments are forwarded for payment records. Cheques are deposited and separated from the documents. After recording the payment information, the document information is keyed.

According to the filing frequency, the system calculates the proper due date and identifies non-filers every two weeks. Non-respondent traders are reminded either through a letter or through personal contact by telephone.

While most of the traders pay tax on time,[25] some traders neither submit returns nor pay the tax despite the reminders sent by the computer centre. In such cases, the collection wing of the department takes up the matter and performs the collection activity. The main function of this department is to identify non-compliant accounts and to recover revenues due to government.

Based upon pre-defined selection criteria, the processing system selects documents for review and verification or audit. In addition, this centre edits and validates all returns, remittances, and payments including rejected cheques that are transmitted via the data entry system. It also validates refund/rebate documents.

*Collection centre*: First of all, this centre identifies non-compliant accounts. It then determines the degree of non-compliance. Further, the centre sends notices to taxpayers requesting due funds, tax returns, or both. Thereafter, the process requires operators to make calls and request notices asking taxpayers to fulfil their obligations. To evaluate non-compliance, batch programs are assigned. These programmes evaluate the accounts that have been identified as being non-compliant. Evaluation will decide which compliance process the account should be in, or whether the account should be removed from the non-compliant status.

## D. Auditing of traders

This component of GST management addresses the issues related to the auditing of traders. This includes traditional post-payment (control type) audits as well as audit review required for GST-related prepayment (rebate review) functions. Primary functions of the system are to provide:
(1) correct and timely access to the client's current status and its history;
(2) an integrated business solution to the management of GST; and
(3) information related to an audit for the analysis and the monitoring of audit operations.

The audit wing helps in the application of audit policies and standards as well as quality control. For this purpose, the VAT authorities follow the theory of risk management and apply it to all traders (2.3 million in 1999). It then selects 3 to 4% of traders for audit every year.

While the information available through the GST returns is limited, the major sources of information are returns for income tax (T1 returns dealing with sole proprietors and T2 returns dealing with corporate entities), which provide elaborate information to the department for audit selection. The credit returns are richly profiled independently from debit (payment) returns. The credit returns rely on computerized edits that are built into the above described system of return processing.

Benchmark ratios for different variables (such as input tax credit (ITC/GST ratio) are applied to all traders (whether small proprietors or companies). These ratios vary according to the type of industry and the location of the firms.[26] Standard ratios are calculated independently for industries as per size. In addition, other factors are also taken into account for the selection of traders for auditing. These include sector profile, industry profile, financial ratios, standard industrial classification (SIC), constancy in filing returns, large fluctuations in GST collections, claims of input tax credit without corresponding reference of fixed assets, and deregistration (see Annex I).

The audit information management system (AIMS) helps in verification, enforcement and compliance (VEC) of traders. The information technology branch (ITB) supports this work.

The audit branch is responsible for the fieldwork of audit and assessment. Each auditor is given a specific audit assignment. To enable the auditor to be efficient in his work, he is provided with a laptop, downloaded with the relevant information concerning the selected dealer. It also contains information about other traders in the same industry group as well as for the group of traders at a macro level.

The selection of audit is based on "risk assessment" designed to take into account the information from local offices, results of auditing done in the past and the results of the computer assessment of the returns received in the department. Also, AIMS uses many other variables to select the traders for auditing. This results in selection of a low percentage of small and medium-sized traders and a high proportion of large traders.

In this process, all the new registrants are automatically selected if the input claim is higher than CAD 500. While the effort of the VAT authorities is always to carry out such audits to newly registered traders, generally this is not followed. There is, of course, not much revenue at stake. Large traders (approximately 300) and their affiliates (approximately 6,000) are selected for audit each year. Exporters have a separate system of selection. These are considered to be in the high-risk category. Traders with nil sales but having input credit, and traders showing variations in credit claims are also selected separately. The Industrial Code is also a base for the selection of some industries, which are prone to high risk. Credit limits are fixed for each trader after an analysis of trends in input credit over a given period. The limit could range between CAD 1 and CAD 100, depending on the business. Any variation in the claim higher than the limit attracts the attention of the system for selection. Agriculture being zero rated, requires a refund of input tax. Hence, an inspection visit is made prior to authorize the input tax entitlement. In all, audits result in significant revenue

25. Generally, 95% of the revenue collected by the VAT authorities is the tax shown in the return and paid on time by the dealer. This is also known as "admitted tax".
26. The department undertakes studies that give details of these benchmark ratios.





recovery. The recovery, however, varies from industry to industry, as shown in Table 3.

Table 3: GST audit recovery by sectors (1994-95)

| Industry sector | Percentage of GST* |
|---|---|
| finance and insurance | 7.7 |
| logging and forestry | 5.91 |
| transport and storage | 5.81 |
| health and social services | 4.85 |
| construction | 2.7 |
| other services | 2.25 |
| fishing and trapping | 2.19 |
| real estate/insurance agent | 2 |
| educational services | 1.95 |
| mining quarries and oil | 1.94 |
| wholesale trade | 1.93 |
| agriculture | 1.7 |
| retail trade | 1.6 |
| business services | 1.5 |
| not classified | 1.3 |
| accommodation/food/beverage | 1.2 |
| government services | 1 |
| manufacturing | 0.7 |
| communication, utilities | 0.2 |

* Refers to audit recovery as a percentage of taxes initially assessed.

The investigation unit is assigned a particular trader for audit if he is found to be involved in fraud. Being time consuming, investigations are done for the purposes of enforcement as opposed to revenue collection.

All audit results are maintained in the system for each client for future reference and analysis. This analysis is aimed at both the development of taxpayer risk profiles and evaluation of program effectiveness and operational efficiency.

This subsystem consists of two components: the batch subsystem and an online subsystem. The former contains transactions that are responsible for capturing audit results, creation of audit history, interfacing with refund/rebate to perform the completion of prepayment audits. It generates an interface file to be used by the rebate system for approval of waived requests for a rebate audit.

Audit results cover both the requirements for post- and prepayment audits. The results are uploaded from the local districts (batch process) or entered through the online screens.

## E. Management information system (MIS)

The objective of MIS is to contribute towards a system that renders efficiency in the overall governance of the tax. In this endeavour, MIS analyses information needs and looks into its overall ingredients. Taking all these aspects into account, it capacitates the management to get requisite information of all the units of the system.

The first important ingredient of MIS is the data capture system, which is an automated component of GST management. The primary function of this system relates to the payment process. That is, it records all revenue receipts and bank deposits, and ensures transaction balancing as well as batch balancing. It includes capturing documents relating to all relevant information for GST for later trader account update and providing control reports to support the "payment capture" and "document capture" functions. In addition it deals with transmitting verified and consolidated transaction data to the GST mainframe in the required batch formats.

MIS also helps in the processing of returns. In this context, it keys in all the information from returns received by the VAT authorities. Through this process, it validates and updates accounts of traders.

It also enables managers in recording the results of completed audits to ensure that audit-originated reassessments are issued and that they are correct. It helps managers to control the inventory of files selected for audit and helps in all management operations. It thus helps in categorizing accounts by size, industry type, time since last audit and collection history. Also, MIS helps in random selection of traders with different size categories, types of traders, varying account profiles to industry averages and industries showing unusual patterns.

Information on accounting is another major ingredient of MIS. Most of the relevant documents are processed by the data capture sub-system.[27] All these data become the basis for recording all financial activities.

The overall system of MIS in Canada, as shown in Annex II, is completely integrated. The data capture starts from the time of registration, goes on to payment of tax and processing of returns and draws information from the mainframe and data warehouse for the selection of cases for audit. Investigation is also recorded into the system and all other agencies also provide necessary information.

## F. Appeals

This functional area is responsible for the direction of all programme policies and activities concerning objections and appeals resulting from the application of GST. In this context, it follows a three-tier approach. First, it attempts to sort out problems with the taxpayers through mutual and informal discussion. Generally, this procedure resolves many of the problems. As a next step, an appeal is made before the appellate authority. This and the next appeal become progressively more formal and the tax has to be paid before the appeal is filed.

27. Some documents are also received from MRQ (Ministère des Revenues du Quebec) and EDI (Electronic Data Interface). These are also used in the system.

### G. Taxpayer services

One of the important activities of GST management is the emphasis on taxpayers services. The client service directorate brings out publications in simple language for the use of taxpayers' responds to ministerial correspondence and helps clients file their tax returns correctly. It also assists taxpayers through the use of automated telephone systems and internet to understand their obligations and entitlements.

As a conclusion, the structure and the process of adoption of GST in Canada suggest that it had a hostile reception from the people in Canada. The resentment persisted well after the tax came into operation. So much so that the Liberal Party that came to power in 1993 made an electoral pledge to abolish or replace it. The election pledge led the new government to ask the Standing Finance Committee of the House of Commons to suggest alternatives.[28] That Committee presented its report in June 1994 with the following observations:

- the GST has a narrow base. This has resulted from the exclusion of a number of goods and services from the base;[29]
- the tax is extremely complex. This is mainly caused by exclusions based on minute commercial differences among commodities;[30]
- there is no harmony between federal and provincial tax systems. Operation of the two taxes, each with its own structure and administrative procedures, makes life difficult for the traders.

There was also a general perception that GST had led to the proliferation of the underground economy, even though there are other contributory factors (such as overvalued currency).[31]

Also, the system of governance of GST suggests that most of the procedures at the time of its introduction were performed manually. Computerization has been implemented and brought to a high level of sophistication in recent years. This has helped Canada Customs and Revenue Agency (CCRA) in efficient administration of the newly introduced GST.

## VI. LESSONS FOR INDIA

India's indirect tax system is such that under the constitution, the central government has the authority to impose a broad spectrum of excise duties on production or manufacture while the States are assigned the power to levy tax on sales or purchases of goods. Due to this dichotomy of authority under the constitution, India has been rather slow in the adoption of VAT. Also, it has created an obstacle in introducing the European-style VAT in India, although over the years, tax reform committees have recommended that central excise duty, sales tax, and other domestic trade taxes be replaced by a comprehensive VAT that could tax all commodities and services.[32]

However, India has also attempted for almost a decade to introduce VAT at the federal level. Beginning in 1986, it gradually introduced the principles of VAT in its union excise duties. Over time, the structure of union excise duties has been reformed and procedures of VAT have been extended to most of the commodities. It is now called Central VAT (CenVAT),[33] referring to a VAT levied by the federal government. However, owing to the constraints of the constitution, the CenVAT is confined to the manufacturing level only.

At the sub-national (state) level, India has a system of extensive sales taxes. These are mostly levied on the first sale within the state, known as the first-point sales tax. Some of the states levy tax on the last sale of many of the commodities, which is akin to retail sales tax of Canada.[34] Attempts are, however, afoot to replace the existing sales tax by VAT from 1 April 2002. The states are accordingly preparing for the same and the Empowered Committee of State Finance Ministers appointed by the federal government is overseeing the progress and providing due guidance.

For a comprehensive VAT in India to be successfully implemented, it is important to learn from the Canadian experience that the tax procedures have to be changed considerably. It is also important that information technology is updated prior to the introduction of VAT. This is possible provided gradual and continuous efforts at computerization from the headquarters level down to the lowest ladder of administration at district level are introduced.

Some of the important lessons that could be drawn from the structure and management of GST in Canada are as follows:

- Canada has a variety of systems to harmonize federal and sub-national VATs. One of the systems is that of independent GST and QST levied by the federal and

28. For similar resentment against the VAT in Norway, see Sijbren Cnossen, "VAT and RST: A Comparison", *Canadian Tax Journal*, 1987, 35, 3.
29. Only about two thirds of the consumer expenditure is under the tax.
30. For details, see Richard M. Bird, "The Cost and Complexity of Canada's VAT: The GST in International Perspective", *Tax Notes International*, Vol. 8, 3 January 1994, pp. 37-47 and Plamondon & Associated Inc., *GST Compliance Costs for Small Business in Canada*, A Study for the Department of Finance, 1993.
31. For details, see Canada (1994, see footnote 3), p. 16.
32. Such recommendations were initially put forward by the Indirect Enquiry Committee under the chairmanship of Shi L. K. Jha [See, Government of India, *Report of the Indirect Taxation Enquiry Committee*, Ministry of Finance, New Delhi 1978.] These recommendations were forcefully presented for the central as well as state taxes in an important report on tax reforms under the chairmanship of Prof. R J Chelliah in 1991 [See Government of India, *Tax Reforms Committee, Interim and Final Reports*, Ministry of Finance, New Delhi 1991-1993].
33. CenVAT is now levied on almost all goods and collected and enforced through books of accounts. Contrary to what existed earlier, CenVAT is now not confined to specifically defined goods. For details, see Mahesh C. Purohit, "Road Map for National and Sub-National VATs in India", paper presented at *India States Forum* on 23-25 November 2000.
34. Delhi, Haryana and Punjab levy sales tax on a specified list of commodities at the stage of last sale, known as last-point sales tax. Notwithstanding the provision of last-point tax, most of the revenue in these states is derived from tax on the first sale.





provincial governments respectively, but both collected by the province (Quebec). At the same time there is the model of HST, levied and collected by the federal government, but the provincial share is distributed to the provinces on the basis of consumption. India could also think of having a harmonized central and state VAT in the states that are not so well administered. At the same time the states having a very good system of administration could be given the power to collect CenVAT along with state VAT, as in Quebec.

- Visibility was an issue in opposing GST in Canada. Unlike in the European Union (or as recently adopted in Australia), retail prices in Canada are quoted before tax and the tax is applied at the counter. India should also follow the pattern of tax inclusive prices. This would avoid the problem of collusion between the buyer and seller in avoiding payment of tax. This would also avoid any opposition to the VAT by the public at large.
- It is extremely important that an account-based approach is adopted for VAT compliance and enforcement purposes. This is the most important change that has to be incorporated in India. In terms of compliance and enforcement, verification of sales has to be uppermost under VAT.
- The details of procedures of management of GST bring to the fore the issue of physical internal controls and checks that are applied to different activities. Batch numbers and control numbers have various checks that can reveal inconsistency in the system. These internal controls provide information on loose ends to help the department to select the traders for special audit. In the context of introduction of VAT in India, it is important that India provides for physical internal controls before it switches over to a system of audit selection (assessment) by the department.
- A smooth implementation of sub-national VATs requires a centralized mechanism to oversee its operations and take remedial measures, if necessary, as is being done by the Parliament of the European Union. India requires two-tier machinery viz. an apex body dealing with policy issues and a functional body overseeing the operations. Such a regulatory body in the form of a VAT Council of States comprising finance ministers has already been appointed by the Union Finance Minister to provide policy guidance and to supervise the implementation of these decisions. Also, a Standing Council of Commissioners[35] has been set up to look into the operational problems of VAT implementation.
- Management of VAT in India calls for separation of duties of different functionaries of the VAT department. For example, the work related to revenue receipts and the follow up action of the defaulters is an important component of VAT management. It requires special attention given to offenders. Management of GST takes care of this problem by contacting traders by telephone, sending them reminders and visiting them personally. Auditors are specialized officers trained to look into the accounts of the traders. They also have the experience of attempting risk analysis and working in the verification and enforcement branch. In some countries this is taken care of by appointing departmental officers with a general qualification (say, first degree) and then training them in special functional areas such as audit or electronic commerce. India must also attempt functional reorganization of the tax authorities to provide for separation of duties of different officers. This is essential to ensure the VAT authorities operate efficiently.
- The integrated management information system (MIS) is a prerequisite for obtaining all the information from tax returns of individuals and of corporations. This would enable the tax department to have access to necessary data for "risk management". In fact, the coordination of the VAT department with all the tax departments is extremely useful. In India, at present the administration of federal taxes such as income tax and CenVAT is quite independent. This is equally true of sales tax. In the context of the introduction of VAT, it is important to develop integrated procedures that would cover all the tax departments.
- The most important component being risk management, the tax department has to make use of the information collected through registration, submission of VAT returns, claims for input credit, refunds and information flowing from income tax returns etc. This information is used to classify traders into small, medium and large categories. "Risk management" is attempted for selecting traders from different size groups in order to perform a thorough audit. In the Indian context, it is important to evolve procedures to undertake "risk management" prior to the introduction of VAT.
- Finally, it is of paramount importance that India concentrates on taxpayers services and on reducing interaction between traders and the department.[36] Availability of authentic information should be a right for the traders. Requisite publicity of their rights and duties with do's and don'ts and use of telephone and electronic means would help developing proper provisions for introducing VAT in India. The taxpayer services department of GST lays special emphasis on providing requisite information in a simplified format to all traders. In fact, the departmental effort is to provide printed brochures and leaflets including return forms well before the due date of submission. Also, it is their constant endeavour to provide the traders with

35. See Resolution No. F. No. 31/11/99-ST dated 24 February 2000, Department of Revenue, Ministry of Finance, Government of India, New Delhi.
36. In the Indian context, interaction between traders and the VAT authorities is likely to increase corruption. Therefore, the emphasis should be on increasing taxpayer services and reducing interaction with the authorities.

requisite information electronically, mostly online. The traders willing to register for GST could submit the requisite information through e-mail and get their BN from the relevant officer electronically. The officer concerned helps them personally in completing their returns. Answers to their queries are provided by telephone or through e-mail. Traders' rights and duties are explained to them to enable them to do the needful and avoid mistakes.

## VII. CONCLUSION

The above lessons for India, both from the structure and governance of GST in Canada, could be of great relevance when India is engaged in preparing suitable procedures for CenVAT and attempting to introduce state VAT in the near future to replace the sub-national sales taxes at the first point of sale within the state. For state VAT, the lessons are relevant both for the structure and the governance of the tax.





## Annex - I: Sample list of benchmark ratios for audit selection

LIST IDENT T2714A

T2 SELECTION LIST

LISTING BY INDUSTRY - STANDARD INDUSTRIAL CODE : 8660
GROSS REVENUE 0 K TO 99,999,999 K

DISTRICT: HEADQUARTERS

| Sr. No. | CORPORATION NAME / CITY PROVINCE, POSTAL CODE / CORP TYPE, LAST YR AUD / SCREEN | AREA SUB-CODES | CORP. NO. PAYDC SIC/GROUP | FISCAL YEAR END YY/MM/DD | GROSS REV (000) | NET INC (000) | TAX INC (000) | TAX AT RISK ISSUES LANG.GR/LVL |
|---|---|---|---|---|---|---|---|---|
| 1 | A.B.C. CONSTRUCTION COMPANY LTD 09 | | 1234 5678 | 93-06-30 | 605 | 0 | 0 | HIGH RISK |
| | BRANTFORD ON A1A-1A1 | 07 00 00 00 | AAA 123456 | 92-06-30 | 1276 | 38 | 12 | 012 045 096 |
| | CCPC 91 | | 8660 / 45 | 91-06-30 | 871 | 12 | 8 | ENG. AU-01 |

PROFILE REPORT FOR T1'S

APPENDIX B1
LIST IDENT. T174A PAGE NUMBER
RUN NO. 9 REQUESTED ON
ISSUE NBR : 01 HIGHEST POTENTIAL FILES

T1 SELECTION LIST

SEQUENCE NUMBER : 3000001

2 TAXPAYER NAME.................: XYZ
ADDRESS ............................: FIRST AVENUE
CITY, PROVINCE ..................: BRANTFORD ON
POSTAL CODE ......................: A1A - 1A1
DATE OF BIRTH....................: 1945-11-28

S.I.N. NUMBER ...................: 123-456-789
SPOUSE
NAME................................ : ABC
S.I.N. NO............................: 345-567-987
NO. DEPENDANTS.............: X

SIC : 9999 - RESIDENTIAL CONSTRUCTION
ASSESS CAT CODE : 5 BUSINESS

PRIOR AUDIT RESULTS
DATE COMPLETED : 92-06-15
LATEST YR AUD......: 91
TYPE OF AUDIT.......: 2 - RESTRICTED
RESULTS(NPV).......: 95000
PENALTIES..............: N/A

CAAS AREA CODE : 09
CAAS YEAR CODE : 94
CAAS LAST LISTED : 15/01/94
CAAS SCORE : HIGH
ASSESSING
TAXATION YEAR

NEIGHBOURHOOD : A9A - 9A
AVE TOT INC : 35,000
DECILE - TSO : 06

| | 1994 (YEAR 1) | 1993 (YEAR 2) | 1992 (YEAR3) | CHANGE FROM PREVIOUS YEAR YRS (1-2) | % | YRS (2-3) | % |
|---|---|---|---|---|---|---|---|
| EMPLOYMENT INCOME - T4 | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| COMMISSION INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| UNEMPLOYMENT INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| DIVIDEND INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| INVESTMENT INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET PARTNERSHIP INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS RENTAL INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET RENTAL INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| OTHER INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS BUSINESS INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET BUSINESS INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS PROFESSIONAL INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET PROFESSIONAL INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS COMMISSION INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |

| | 1994 (YEAR 1) | 1993 (YEAR 2) | 1992 (YEAR3) | CHANGE FROM PREVIOUS YEAR YRS (1-2) | % | YRS (2-3) | % |
|---|---|---|---|---|---|---|---|
| NET COMMISSION INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS FARMING INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET FARMING INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| GROSS FISHING INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| NET FISHING INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| WORKER COMPENSATION PAYMENTS | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| OTHER SOURCES OF INC (CALC) | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| TOTAL INCOME | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| PRSP CONTRIBUTORS | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| ALLOWABLE BUS INVEST LOSS | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| ALIMONY | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| CARRYING CHARGES & INTEREST | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| OTHER EMPLOYMENT EXPENSES | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| OTHER DEDUCTIONS | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |
| CAP GAINS DED SML BUS SHARE | 9.999.999 | 9.999.999 | 9.999.999 | 9.999.999 | 999 | 9.999.999 | 999 |





## Annex II: Schematic diagram of MIS for governance of GST in Canada