CII MSME Policy Dialogue Series 2016-17
Impact of GST on the Indian MSME Sector

Background Note

September 2016
Overview

The recent introduction of Goods and Services Tax (GST) is significant step in the area of taxation reforms in India. GST attempts to amalgamate several Central and State taxes into a simple and unified indirect tax regime which would mitigate the cascading or double taxation effects of the indirect tax system, lower transactions and logistics costs, create a common national market throughout the country and provide a strong propulsion to investments and growth. It will also impact the tax structure, tax incidence, tax computation, tax payment, compliance, credit utilization and reporting in the country. The simple and transparent structure leveraged by technological tools will also address tax evasion in the country through its easy manageability and monitoring. Bringing the indirect tax system at par with most countries in the world, GST would also enhance the national and global competitiveness of Indian products.

Under the GST regime, credits of input taxes paid at each stage will be available in the subsequent stage of value addition, which makes GST essentially a tax only on value addition at each stage. In place of the erstwhile practise of the levying of indirect taxation simultaneously and variously by the states and the Centre, the GST is a system of common indirect taxation with equal partnership between the Centre and the State.

The Indian MSME sector is critical for the growth and development of the nation. The contribution of Indian MSMEs to the national output, employment generation, exports and industrial output is enormous. But a complicated compliances system and a rigid taxation regime place added limits on the growth potential of these enterprises. The Indian MSME sector will gain tremendously form the GST and the implementation of this taxation regime has been a recurring policy recommendation by various stakeholders engaged in initiatives for the amelioration of the SME sector in India. GST has the potential to increase tax compliance amongst MSMEs in India, significantly reduce their input cost and cultivate financial discipline among MSMEs, leading to an increase in revenue collection for the government and a simplified tax regime for these enterprises.

But there are also some areas of concern for MSMEs relating to the GST law. The biggest one which has the capability to derail the process of a robust tax regime being Input Tax Credit and availing it, the transference of responsibility and liability of tax remittance to the customer in the event of failure of supplier in meeting the compliance requirement, etc. There are other issues around payment of GST on advances, taxing free supplies, complications around sales returns etc. A careful analysis of the impact of GST on various nosiness processes as well as a studied examination of the various underlying features and concepts will be crucial to enhance the preparedness of Indian industry, especially the Indian MSME.
sector, to adapt to this new indirect tax regime touted as a path breaking step in the area of taxation reforms in the country.

The Existing Tax System in India

According to the Constitution of India, the government has the right to levy taxes on individuals and organizations. However, the constitution states that no one has the right to levy or charge taxes except the authority of law. Whatever tax is being charged has to be backed by the law passed by the legislature or the parliament.

The tax system in India is mainly a three tier system which is distributed between the Central Government, State Governments and local governing organizations such as local councils and the municipalities. Direct and indirect taxes include all the different types of taxes levied by the government in India.

The Central Board of Revenue or Department of Revenue is the apex body charged with the administration of taxes. It is a part of Ministry of Finance. Initially the Board was in charge of both direct and indirect taxes. However, when the administration of taxes became too unwieldy, the Board was split up into two, namely the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) with effect from 1 January 1964.

Direct Taxes

Direct taxes include the taxes that are imposed directly on the taxpayer and cannot be transferred or shifted to another person. These taxes are paid by an individual directly to the government. The burden of the tax falls flatly on the individual who earns a taxable income.

Some of the important direct taxes imposed in India include the following:

- **Income Tax:** This is imposed on the incomes of individuals, Hindu Undivided Families (HUF), firms, co-operative societies, trusts, etc. and is based on their residential status.
- **Corporation Tax:** This is imposed on the income of companies and business organizations and is based on their worldwide transactions.
- **Wealth Tax:** The wealth tax, governed by the Wealth Tax Act, allows the government to impose a tax on the net wealth of a person, an HUF or a company.
- **Property Tax or House Tax:** This is a local tax on buildings, along with appurtenant land, and imposed on owners.
- **Capital Gains Tax:** This is levied on the income derived from the sale of assets or investments.
• **Inheritance Tax or Estate Tax or Death Duty**: This arises at the event of the death of an individual and is a tax on the total value of the money and property of a person who has died.

• **Gift Tax**: This is a tax on the gifts received by any individual or Hindu Undivided Family (HUF) in excess of Rs. 50,000 in a year.

**Indirect Taxes**

Indirect Taxes are those taxes which are levied on goods and services. These are collected by an intermediary from the person who bears the ultimate economic burden of the tax. An indirect tax is one that can be shifted by the taxpayer to someone else. An indirect tax may increase the price of a good so that consumers are actually paying the tax by paying more for the products.

Some of the important indirect taxes imposed in India include the following:

• **Sales Tax**: Sales tax is a tax that is levied on the sale of a product. This product can be something that was produced in India or imported and can even cover services rendered. This tax is levied on the seller of the product who then transfers it onto the person who buys said product with the sales tax added to the price of the product.

• **Service Tax**: Service tax is added to services provided in India. It is not applicable on goods but on companies that provide services.

• **Custom Duty**: These are levied on imports into the country via land, air or sea. Customs duty ensures that goods for other countries are taxed.

• **Excise Duty or Central Value Added Tax or CENVAT**: This is a tax that is levied on all the goods manufactured or produced in India. This tax is collected by the government from the manufacturer of the goods. It can also be collected from those entities that receive manufactured goods and employ people to transport the goods from the manufacturer to themselves.

• **Value Added Tax (VAT)**: The value added tax is a tax that is levied at the discretion of the state government. The tax is levied on various goods sold in the state and the amount of the tax is decided by the state itself.

• **Octroi**: This levy by state governments is meant to ensure that goods crossing state borders within India are taxed appropriately. It functions in much the same way as customs duty does.
- **Securities Transaction Tax (STT):** STT is a tax being levied on all transactions done on the stock exchanges. STT is applicable on purchase or sale of equity shares, derivatives, equity oriented funds and equity oriented mutual funds.

**The Extant Indirect Tax Regime in India**

<table>
<thead>
<tr>
<th>Central Levies</th>
<th>State Levies</th>
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<tbody>
<tr>
<td>• Customs Duty</td>
<td>• Value Added Tax (VAT)</td>
</tr>
<tr>
<td>• Excise Duty</td>
<td>• Luxury Tax</td>
</tr>
<tr>
<td>• Central Sales Tax</td>
<td>• Electricity Duty</td>
</tr>
<tr>
<td>• Service Tax</td>
<td>• Entertainment Tax</td>
</tr>
<tr>
<td></td>
<td>• Entry Tax and Octroi</td>
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</tbody>
</table>

**A Critique of the Existing Taxation System in India**

Both direct and indirect taxes are important for the country as they are intricately linked with the overall economy. Taxes provide the government with the resources required to undertake economic development of the nation and encourage savings and investments. But the multiplicity of indirect taxes and high rates of taxation have made the indirect tax structure quite complex in India, seriously undermining the competitiveness of trade and industry and crippling the growth of economy. By increasing the price of goods and services, the indirect tax system may even enhance inflation in the economy. Through their virtue of non-transferability, direct taxes help in reducing inequalities and are considered to be progressive while indirect taxes enhance inequalities and are considered to be regressive. In terms of allocative effects too, the collection of indirect taxes is scattered across parties and consumers' preferences of goods is distorted from the price variations due to indirect taxes.

In spite of some shared features, each of the indirect taxes differ drastically from each other in various aspect such as the purpose of levy, taxable events, rates, threshold limits, etc. Each of these taxes require separate compliances and they all have independent exemption/concession lists.
Issues with the Existing Indirect Tax System:

- **Multiplicity of Indirect Taxes:** The multiplicity of indirect taxes, each requiring its own set of compliances, procedures, and other regulatory requirements imposes significant costs and burdens on businesses, especially MSMEs which are inherently crunched for resources.

- **Multiple Points of Taxation:** The point of taxation refers to the time when a particular tax becomes applicable. Each indirect tax has a distinct point of taxation which results in the same goods being taxed twice or thrice. This also results in multiple compliance requirements or over payments of taxes which are especially challenging for MSMEs.

The following table encloses the points of taxation for some of the important indirect taxes in India:

<table>
<thead>
<tr>
<th>Name of Indirect Tax / Levy</th>
<th>Point of Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customs Duty</td>
<td>Passing through the customs frontier</td>
</tr>
<tr>
<td>Central Sales Tax</td>
<td>Sale of goods between states</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>Sale of goods within states</td>
</tr>
<tr>
<td>Excise Duty</td>
<td>Manufacture of goods</td>
</tr>
<tr>
<td>Service Tax</td>
<td>Provision of service</td>
</tr>
<tr>
<td>Entry Tax / Octroi</td>
<td>Entry of goods in states</td>
</tr>
</tbody>
</table>

- **Lack of Uniformity in Tax Rates:** The rate of taxation varies drastically for different taxes or for the same tax between different states which adversely impacts the consumer preferences and saleability of goods and services. The applicable rate of VAT/CST may be 12.5% in one State while 14% or 5% in another. Moreover, the same product may or may not be chargeable for additional Local Body Tax. Further, the local body tax rate may be 2% in one city and 5% in another.

A manufacturer sourcing inputs from various states or supplying goods to various states is required to track the various tax rates applicable to various products under various levies in various states which is a herculean task for MSMEs and imposes significant compliance burden on them.

- **Lack of Uniformity in Threshold Limits and Exemptions Criteria:** Various relaxations are provided to MSMEs under various indirect taxes applicable to businesses in order to reduce their compliance and cost burden. However, the threshold limits and eligibility
criteria under various taxes differ significantly. As such, often MSMEs are unaware of the exemptions available to them and end up paying taxes inapplicable to them or omit paying the applicable taxes thus being liable to pay huge penalties.

- **Multiplicity of Penalties**: Multiplicity of taxes result in multiple penalties of varying magnitude. Moreover, with the involvement of various tax officers, these penalties are often discretionary in nature and lead to the harassment of businesses and loss of their competitiveness.

- **Frequent Changes in Various Laws**: Most indirect taxes, their rates, the rules governing them, etc. are modified several times during a year. Moreover, there is no mechanism to notify businesses about these changes. Lack of updates on the changes may lead to businesses defaulting and attracting heavy penalties. The transferability of indirect taxes may lead to the transference of the penalties to end consumers which may even result in loss of business.

- **Significant Compliance Burden**: Multiplicity of taxes and disparity between these taxes impose significant compliance burden on businesses in terms of quantum as well as costs.

- **Loss of Export Competitiveness**: The cascading effect of the indirect tax system inflated the prices of Indian goods which renders them uncompetitive in the international markets thus affecting the exports from the country.

- **Deterrent for Investments and Global Business Opportunity**: The multi-layered and complex tax structure in India is at odds with the uniform indirect tax structure followed by most other countries in the world. This acts as a deterrent for global businesses to do business in India or investing in India.

These are some of the key arguments in favour of replacing this rigid and complex tax regime with an efficient, comprehensive and simple tax structure which enhances the productivity of Indian industry and propels investments and growth while simultaneously bringing the Indian tax structure at par globally.

**The Goods and Services Tax (GST)**

With the approval of the President, the 122nd Constitution Amendment Bill for GST has been passed in the Parliament after being duly ratified by more than 50% of state legislatures. The Government is committed to replace all the indirect taxes levied on goods and services by the Centre and States and implement GST by April 2017.
The introduction of GST is one of the biggest taxation reforms and is all set to integrate various State economies and boost overall growth. It will also help in increasing the GDP of the country by 1-1.5%. Such a tax system has already been implemented worldwide around 150 countries.

GST is a comprehensive tax levy on manufacture, sale and consumption of goods and services at a national level. It will replace a number of indirect taxes being levied by union and State governments, remove the cascading effect of indirect taxation and create a national market with seamless movement of goods and services across the country.

The GST structure would follow the destination principle. Accordingly, imports would be subject to GST, while exports would be zero-rated. In the case of inter-state transactions within India, Integrated GST would apply in the state of destination as opposed to that of origin which will be an aggregate of CGST and the SGST of the destination state.

**Central and State Taxes Subsumed in GST**

**CENTRAL TAXES**
- Central Excise Duty
- Duties of Excise (Medicinal and Toilet Preparation)
- Additional Duties of Excise (Special Important Goods)
- Additional Duties of Excise (Textile Products)
- Additional Duties of Customs (CVD)
- Special Additional Duty of Customs (SAD)
- Service Tax
- Cesses and Surcharges

**STATE TAXES**
- State VAT
- Central Sales Tax
- Purchase Tax
- Luxury Tax
- Entry Tax
- Entertainment Tax
- Taxes on Advertisements
- Taxes on Lotteries, Betting and Gambling
- State Cesses and Surcharges

**Salient Features of GST**

The important features of GST are summarized below:

- GST would be applicable on supply of goods or services as against the present concept of tax on the manufacture of goods or on sale of goods or on provision of services.
Supply is defined as: all forms of supply of goods and/or services such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business. It also includes import of service. GST would be a destination based tax as against the present concept of origin based tax.

- Time of Supply: The time of supply of goods shall be the earliest of the following:
  
a) the date on which the goods are removed by the supplier, where the supply of goods require removal; or
b) the date on which the goods are made available where the supply does not require removal; or
c) the date on which the supplier issues invoices with respect to the supply where the above two situations do not apply; or
d) the date on which the recipient shows the receipt of the goods in his books of accounts.

- Unlike goods, in the case of services, the time of supply is determined by the fact whether the invoice for supply of services has been issued within the prescribed period or beyond such prescribed period.

- The GST will be dual with Centre and the States will simultaneously levying it on a common base. The GST to be levied by the Centre would be called Central GST (CGST) and that to be levied by the States would be called State GST (SGST).

- GST would apply to all goods other than crude petroleum, motor spirit, diesel, aviation turbine fuel and natural gas. It would apply to all services barring a few to be specified.

- An Integrated GST (IGST) would be levied on inter-State supply (including stock transfers) of goods or services. This would be collected by the Centre so that the credit chain is not disrupted.

- Under the GST regime, tax is payable by the taxable person on the supply of goods and/or services. Liability to pay tax arises when the taxable person crosses the threshold exemption, i.e. Rs.10 lakhs (Rs. 5 lakhs for NE States).

- Accounts would be settled periodically between the Centre and the State to ensure that the State GST components is transferred to the destination state where the goods and services are eventually consumed.
• Import of goods or services would be treated as inter-state supplies and would be subject to IGST in addition to the applicable customs duties.

• CGST, SGST & IGST would be levied at rates to be mutually agreed upon by the Centre and the States under the aegis of the GST Council (GSTC).

• GST would apply to all goods and services except on Alcohol for human consumption, Electricity and Real Estate.

• A common threshold exemption would apply to both CGST and SGST. Taxpayers with a turnover below it would be exempt from GST. A compounding option (i.e. to pay tax at a flat rate without credits) would be available to small taxpayers below a certain threshold. The threshold exemption and compounding scheme would be optional.

• Credit of CGST paid on inputs may be used only for paying CGST on the output and the credit of SGST paid on inputs may be used only for paying SGST. In other words, the two streams of input tax credit (ITC) cannot be cross utilised, except in specified circumstances of inter-state supplies, for payment of IGST. The credit would be permitted to be utilised in the following manner:
  a) ITC of CGST allowed for payment of CGST
  b) ITC of SGST allowed for payment of SGST
  c) ITC of CGST allowed for payment of CGST & IGST in that order
  d) ITC of SGST allowed for payment of SGST & IGST in that order
  e) ITC of IGST allowed for payment of IGST, CGST & SGST in that order

• Export of goods / services will be zero rated under GST

• All goods or services likely to be covered under GST except alcohol for human consumption, electricity, sale / purchase of real estate

• Tobacco and tobacco products would be subject to GST. In addition, the Centre would have the power to levy Central Excise duty on these products.

• National Securities Depository Limited (NSDL) and State Bank of India (SBI) will act as the clearing corporation and the clearing bank respectively.

• The taxable event or point of taxation for levying GST will be the supply of goods and services for a consideration. Consideration is defined as under:
  a) Monetary consideration includes currency, cheque, promissory note, letter of credit, draft, pay order, traveller’s cheque, money order, postal remittances and
other similar instruments but does not include currency that is held for its numismatic value.

b) Non-monetary consideration includes goods or services supplied as payment for example in a barter (including part exchange) in the case of services this includes giving up a right, refraining from doing something or agreeing to suffer a loss.

- The CGST and SGST would be levied at rates to be jointly decided by the Centre and States. The rates would be notified on the recommendations of the GST Council.

Returns under the GST

The taxpayer would need to submit periodical returns, in common format as far as possible, to both the Central GST authority and to the concerned State GST authorities. The Government will introduce eight forms namely GSTR-1 to GSTR-8 that will be required to file the GST Tax returns in India. Every trader will be required to file a monthly return as well as an annual return. Separately, they will need to file a return each for purchases and supplies. Small traders, however, may only be required to file returns on a quarterly basis.

Every registered person is required to file a return for the prescribed tax period. A return needs to be filed even if there is no business activity (i.e. Nil Return) during the said tax period of return.

The periodicity of return for different categories of taxpayers is as follows:

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Return</th>
<th>Purpose</th>
<th>Periodicity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>GSTR 1</td>
<td>Outward supplies made by taxpayer (other than compounding taxpayer and ISD)</td>
<td>10th of the next month</td>
</tr>
<tr>
<td>2.</td>
<td>GSTR 2</td>
<td>Inward supplies received by taxpayer (other than compounding taxpayer and ISD)</td>
<td>15th of the next month</td>
</tr>
<tr>
<td>3.</td>
<td>GSTR 3</td>
<td>Monthly return (other than compounding taxpayer and ISD)</td>
<td>20th of the next month</td>
</tr>
<tr>
<td>4.</td>
<td>GSTR 4</td>
<td>Quarterly return for compounding taxpayer</td>
<td>18th of the month next to quarter</td>
</tr>
<tr>
<td>5.</td>
<td>GSTR 5</td>
<td>Periodic return by Non-Resident Foreign Taxpayer</td>
<td>Last day of registration</td>
</tr>
<tr>
<td>6.</td>
<td>GSTR 6</td>
<td>Return for Input Service Distributor (ISD)</td>
<td>15th of the next month</td>
</tr>
<tr>
<td>7.</td>
<td>GSTR 7</td>
<td>Return for Tax Deducted at Source</td>
<td>10th of the next month</td>
</tr>
</tbody>
</table>
Other important points relating to periodicity of return filing are as under:

- Normal / Regular taxpayers (including casual taxpayers) would have to file GSTR-1, GSTR-2 and GSTR-3 for each registration.
- Normal / Regular taxpayers with multiple registrations (for business verticals) within a State would have to file GSTR-1, GSTR-2 and GSTR-3 for each of the registrations separately.
- Compounding taxpayers would have to file GSTR-4.
- Taxpayers otherwise eligible for the compounding scheme can opt against the compounding and file monthly returns and thereby make their supplies eligible for Input Tax Credit.
- Casual/ Non - Resident Taxpayers (other than foreigners) would have to file GSTR-1, GSTR-2 and GSTR-3 returns for the period for which they have obtained registration.
- Non- Resident Taxpayers (foreigners) would be required to file GSTR-5 for the period for which they have obtained registration within a period of seven days after the date of expiry of registration. In case registration period is for more than one month, monthly return(s) would be filed and thereafter return for remaining period would be filed within a period of seven days as stated earlier.
- Annual return (GSTR-8) will be filed by all normal / regular taxpayers. It will be based on financial records. Compounding taxpayer will also file a simple annual return.
- The filing of return would be only through online mode although the facility of offline generation and preparation of returns would be provided. The returns prepared in offline mode would have to be uploaded.

**Input Tax Credit (ITC) under the GST**

Input tax in relation to a taxable person is defined as the IGST and CGST in respect of CGST Act and IGST and SGST in respect of SGST Act, charged on any supply of goods and/or

<table>
<thead>
<tr>
<th></th>
<th>GSTR 8</th>
<th>Annual Return</th>
<th>31st December of next FY</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>9.</td>
<td>ITC Ledger of taxpayer</td>
<td>Continuous</td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Cash Ledger of taxpayer</td>
<td>Continuous</td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>Tax ledger of taxpayer</td>
<td>Continuous</td>
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</tbody>
</table>
services to him which are used, or are intended to be used, in the course or furtherance of his business. Credit of tax paid on capital goods also is permitted to be availed in one instalment.

Input Tax Credit (ITC) is the credit of input tax. Every registered taxable person shall, subject to such conditions and restrictions as may be prescribed and within the time and manner specified, be entitled to take credit of input tax admissible to him in respect of inputs held in stock and inputs contained in semi-finished or finished goods held in stock on the day immediately preceding the date from which he becomes liable to pay tax. The said amount shall be credited to the electronic credit ledger of such person.

In order to avail the ITC, a person must fulfil the following criteria:

a) He should be a registered taxable person.

b) He must be in possession of a tax invoice, debit note, supplementary invoice or such other taxpaying document as may be prescribed, issued by a registered supplier.

c) He must have received the goods / services

d) The tax charged in respect of such supply must have been paid to the credit of the appropriate Government, either in cash or through utilization of input tax credit admissible in respect of the said supply.

e) He must have furnished the return under Section 27

Section 16 (9) of the MGL provides for the negative list with respect to the admissibility of ITC. It has been provided that the ITC on following items cannot be availed:

a) motor vehicles, except when they are supplied in the usual course of business or are used for providing taxable services such as transportation of passengers or goods, and imparting training on motor driving skills

b) goods and / or services provided in relation to food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, membership of a club, health and fitness centre, life insurance, health insurance and travel benefits extended to employees on vacation such as leave or home travel concession, when such goods and/or services are used primarily for personal use or consumption of any employee;

c) goods and/or services acquired by the principal in the execution of works contract when such contract results in construction of immovable property, other than plant and machinery

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d) goods acquired by a principal, the property in which is not transferred (whether as
goods or in some other form) to any other person, which are used in the construction
of immovable property, other than plant and machinery

e) goods and/or services on which tax has been paid under section 8

f) goods and/or services used for private or personal consumption, to the extent they are
so consumed.

The GST Network

Government has set up the Goods and Services Tax Network (GSTN) for the online
administration of the dealer registration process, tax payment and tax return filing and refund
to tax payers with respect to GST. The GSTN is a private company constituted under Section
25 of the Companies Act, 1956 with a 49% shareholding by the government and 51%
shareholding by private financial institutions. The GSTN will help build effective and
convenient interfaces for taxpayers, assist authorities in plugging tax evasion, promote best
practices and provide training to stakeholders. For the registration of taxpayers, a GST
Identification Number (GSTIN) will be allotted which would be a 15-digit alphanumeric code
based on the PAN number. As part of return filing process, taxpayers would need to reconcile
their purchase transaction with those reported by their vendors to be able to avail input tax
credit. GSTN will facilitate this by automatically creating purchase register for taxpayers based
on supply transactions reported by their vendors.

Administration of GST

The Article 279A of the Bill provides for constitution of the GST Council comprising the Union
Finance Minister as the Chairman, the Minister of State (Revenue) and the State
Finance/Taxation Ministers to make recommendations to the Union and the States on
important issues related to GST, such as the GST rates, goods and services that may be
subjected or exempted from GST, threshold limits, principles that govern the place of supply
and finalizing Central, Integrated and State GST legislations. Apex indirect tax body, Central
Board of Excise and Customs, will be renamed as the Central Board of Indirect Tax (CBIT).
CBIT will consist of six members, who will look after GST, Customs, Policy and IT, central
customs and legal issues, training and litigation. Besides, an additional secretary of the
department of revenue, who will be secretary to the GST Council, will be a CBIT member for
Central GST (CGST) and Integrated GST (IGST) related matters. The Directorate General of
Central Excise Intelligence (DGCEI) will be rechristened as Directorate General of Indirect Tax
Intelligence (DGITI).
Benefits of GST

Being hailed as one of the biggest reforms in the Indian tax system, GST offers various benefits over the current tax regime in India. These include simplification of the multi-layer taxation system, transparency in taxation system, reduction in multiplicity of taxes, tax rates and exemptions, mitigation of cascading/double taxation, more efficient neutralization of taxes especially for exports, elimination of the cascading effect, development of common national market allowing for free movement of goods and services across the country, etc. GST would most positively impact the organised manufacturing and the Make in India campaign for goods. It is likely to bring down the present incidence of taxation on goods from 26.5% to 15-20%. The removal of the inter-state barriers facilitating the free flow of goods and services is likely to reduce the logistics costs faced by the industry, bring them down to the world average of about 8%. The inventory costs of industry are also likely to go down.

GST and the Indian MSME Sector

The Indian MSME sector is critical for the growth and development of the nation. The contribution of Indian MSMEs to the national output, employment generation, exports and industrial output is enormous. The Indian MSME sector will gain tremendously from the GST and the implementation of this taxation regime has been a recurring policy recommendation by various stakeholders engaged in initiatives for the amelioration of the SME sector in India. MSMEs are currently required to pay indirect taxes as producers of goods and services and file returns as sellers. This system of double taxation results in high transaction costs and adversely affects their competitiveness.

According to the current practise, MSME units in India typically have to pay four major categories of taxes:

1. The Central Sales Tax (CST) levied by states
2. The Central Excise Tax to the tune of 4% to 16% when an MSME crosses annual revenues of Rs. 1.5 crore
3. Service tax
4. Sales Tax or Value-Added Tax to the tune of 10% to 20% on the final good

By replacing these with a single tax with a common rate across the country, the GST will reduce the costs for MSMEs, save time and enhance their competitiveness. Under the current regime, large enterprises 'stock transfer' goods to other states due to availability of infrastructural resources and thereby avoid the impact of central sales tax (CST) on interstate movement. Post-stock transfer, goods are sold locally on payment of applicable VAT to the buyer, who is eligible to avail of credit against output VAT liability. However, SMEs, owing to
lack of infrastructure, effect inter-state sales (instead of stock transfers) and bear the burden of CST. The CST paid is currently not available as input credit to the buyer against his output VAT liability. The non-availability of input credit increases the cost of the product, thereby, rendering SMEs uncompetitive versus large enterprises.

The major areas of benefit for MSMEs owing to the implementation of the Goods and Services Tax (GST) include the following:

• **Simplification of Compliance Burden:** Excessive compliance burdens imposed by a bevy of indirect taxes has been working against the growth potential of SMEs imposing significant compliance costs on this sector. The proposition to back the GST with a robust and comprehensive IT system called the Goods and Services Tax Network (GSTN) would result in simplification of compliance burden for SMEs through the online availability of registrations, returns, payments, etc. This will eliminate the requirement of manually filing returns which has been a long standing woe for Indian MSMEs.

• **Ease of Doing Business through Uniform Tax Rates and Structure:** The GST will contribute towards enhancing the ease of doing business for Indian MSMEs through the implementation of a uniform tax structure across the country.

• **Reduced Transaction Costs:** The GST regime addresses the issue of cascading of taxes through seamless transfer of tax credits across state boundaries. This will ease the movement of goods and services across the country, minimize cascading of taxes and eliminate the hidden costs of doing business.

• **Enhanced Productivity and Competitiveness:** GST will contribute towards enhancing the national and global competitiveness of Indian MSMEs by way of reducing the transaction costs and bringing down the cost of doing business.

• **Market Expansion for MSMEs in Remote Locations:** The imposition of Central Sales Tax has been a major deterrent for SMEs producing goods in a state to sell their products in other states. Given the nature of MSMEs, they utilize significantly higher local resources to produce their goods and services. The CST has been a major roadblock in the movement of quality and speciality products from one part of the country to another. The GST will create a common market for raw materials, goods and services in the country.

• **Boosting the Export Potential of Local SMEs:** The GST subsumes major Central and State taxes such as the Central Excise Duty, Service Tax, State Value Added Tax, Central
Sales Tax, Stamp Duty, Octroi, etc. This will reduce the cost of goods and services locally manufactured by SMEs situated across the country and enhance their competitiveness in the global market. MSME exporters will receive a major boost with the launch of GST.

- **Enhanced MSME Registrations**: Almost 94% of all Indian MSMEs are unregistered and cannot avail of the various schemes and initiatives by the government to support them. A complicated, burdensome and costly tax regime is one of the most important factors contributing to this. This also renders them ineligible to claim tax set-offs. A simplified tax regime such as the GST will encourage SMEs to register themselves and avail of tax refunds, schemes of the government and also contribute to addressing the issue of tax avoidance.

**The Composition/Compounding Scheme under GST**

The Composition/Compounding Scheme is an alternative simplified scheme for protecting the interests of small tax payers and SMEs. The threshold limit for eligibility of this scheme is Rs. 50 Lakhs. A consensus on compounding or composition scheme was arrived at the GST Council meeting recently where it was decided that traders with gross turnover cut-off of Rs 50 lakh will pay 1-2 per cent tax which is much lower than the GST rate. Person assessing under this scheme shall not collect any tax from the recipient of supplies. Consequently, recipient will not get any credit of tax paid under this scheme (by supplier).

**Key Challenges and Areas of Concern for SMEs with the Implementation of the Model GST Law**

In spite of the perceived benefits, there are also some areas of concern by SMEs associated with the implementation of the GST. Enhanced compliance requirements and a steep reduction in the duty threshold are some problem areas for SMEs. Some other challenges are discussed below:

- **Complex Rules and Compliances**: Compliances may increase for many businesses owing to the requirements to maintain multi-state registers. The law also retains some of the existing input tax credit restrictions and seeks to introduce complex rules for valuing supplies of goods and services between related or associated enterprises. A lot is left in the hands of the assessing officer who has the right to open up books at any point of time.

- **Problems with Availing Input Tax Credit**: Another concern is the ability of the manufacturing and distribution chain to take input credit for the taxes it has paid. The model
law has made input credit availability a combination of several conditions and notified several ways to reverse it later. It is possible that many businesses will be unable to actually take credit and treat the taxes paid for input as a cost. The problems associated with input credit will spill over to commercial decisions around credit period, and increased working capital requirement for the same business activity will invariably result in higher cost in the value chain.

- **Skilling Requirements:** The tight deadline and the complexity of law requires millions of people in the economy to be upskilled. Since every single invoice is critical for the chain to work efficiently, even the lowest data entry operator needs to be adequately trained about the repercussions of errors. Lack of skilled manpower at the disposal of SMEs will grant them a further disadvantage in this respect.

- **Transference of Liability and Payment Linkage:** Another big area of concern relates to the transference of responsibility and liability of tax remittance to the customers of a supplier. If a particular supplier has failed to comply with the law correctly, by furnishing the correct returns and/or making the correct payment, then its customers cannot avail themselves of the input credit; if given, it will be reversed. At present non-payment of tax liability of seller imposes no liability on purchaser. In this proposal, purchaser is fully liable for the tax payment of seller. This will have a huge impact on working capital for the SMEs and has the potential to kill the SME industry. The government’s wish of increasing the tax payer base can evaporate in thin air.

**Implications of the GST on the Services sector**

Recent discussions indicate that the GST rate will be fixed at around 18% for both goods and services. With a wide range of indirect taxes currently applicable to the manufacturing sector, a fixed rate of 18% will be lower than the aggregate rate of tax currently payable by them. But the services industry currently attracts 15% tax. The implementation of GST will make various services costlier. This will have an adverse impact on sectors such as commercial vehicles, telecom, print media, air travel, insurance. The destination based GST will also make computation of tax complicated for services providers providing services to customers across multiple states. The positive factors are that the services sector will be able to avail tax credit under the new regime. GST will also eliminate the double taxation of services such as software which are currently treated both as goods and services.
The Road Ahead

The implementation of GST will be like any other law or statute with a mix of contingent opportunities and challenges for various stakeholders. Policymakers need to be nimble and work closely with industry to ensure an effective legislation that is easy to comply, avoids cascading and provides certainty. The final standard GST rate, exemptions granted, compensations to States etc. will determine the actual benefit to the economy. In this context, a critical area will be to arrive at a consensus on the revenue-neutral rates and the final rate structure.

The government can also adopt measures such as the release of sector specific guidance paper(s) on tax treatment concerning each business sector to effectuate the implementation of GST in a smooth way. In the area of dispute resolution, a conceptual distinction needs to be made between offence cases and assessment cases.

GST brings SMEs at the same footing as large enterprises. This poses daunting task ahead for SMEs to be ready to invest, read and change in the same way as any large-scale player, without appreciating the limited resources available with them.

In the GST scenario, where both the Centre and state are going to tax concurrently along the value chain, taking recourse to the invoice value, representing the amount actually paid or payable can be a solution. Finally, certain pan-India services must be brought under a scheme of centralised registration. They would otherwise be subject to multiple registrations and complex documentation.

The acceptance of GST by general public, businesses and firms will not be an easy task. But advance planning and extending adequate time to industry, continued dialogues between businesses and administrators, engaging with industry on the implementation planning, a reasonable tax-rate, timely release of the legislative documents, can aid in smooth GST implementation.