

CLASSIFICATION UNDER GST

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Introduction:

GST is expected to be implemented from July 2017 as of now. Postponement if any would only be announced in last week of June. GST was supposed to reduce the disputes. In Central Excise classification disputes which were numerous in 1990s disappeared when majority of products in one category were taxed equally and rates were reduced. Now with some categories having nil, 5, 12, 18 & 28 it is expected that the parallel economy would find many reasons to continue and not join the mainstream in the higher bracket products. It is also a 10 years step backwards for India.

The list of rates applicable to goods and services, exemptions, extent and activities under reverse charge under GST regime was released last week. Transitional Rules which have a major impact especially on tax involved the stocks in hand and the returns are still to be finalized. The notifications and the final rules along with the formats are expected to be coming in June.

Industry leaders however knowing that law is not in a good shape are looking forward to early implementation even though they are not ready fearing that delay could lead to GST itself being put in backburner for a few years due to possible political impact.

The rate structure for biri wrapper leaves, biris, biscuits, textiles, footwear, natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewellery; coin, power driven agricultural, horticultural, forestry, poultry keeping or bee-keeping machinery, harvesting or threshing machinery, machines for cleaning, sorting or grading, machinery used in milling industry and parts thereof has not been announced.

The Harmonised System of Nomenclature is expected to be followed to ensure that the classification anywhere in the world matches that in India.

Classification in present Central indirect taxes

Under present law, in central excise the classification of goods involves determining the headings or sub-headings of the First Schedule to the Central Excise Tariff Act 1985 under which the said goods would be covered. It is also necessary to determine eligibility to exemptions, most of which are with reference to the Tariff headings or sub-headings.

Composite vs Mixed supply under GST

Under GST it sets out the tax liability on a composite or a mixed supply shall be determined in the following manner —

- a. a composite supply comprising two or more supplies, one of which is a principal supply, shall be **treated as a supply of such principal supply**;
- b. a mixed supply comprising two or more supplies shall be treated as supply of that particular supply which **attracts the highest rate of tax**.

For this we need to understand what is composite and what is mixed supply, which is discussed below.

Composite Supply:

Section 2(30) “composite supply” means a supply made by a taxable person to a recipient comprising two or more supplies of goods or services, or any combination thereof, which are naturally bundled and supplied in conjunction with each other in the ordinary course of business, one of which is a principal supply;

Composite supply comprising of two or more supplies, one of which is principal supply shall be treated as supply of such principal supply.

Example: Where goods such as fans are supplied and installation done at buyer place, the supply of fan and installation of fan is a composite supply and **supply of fan is the principal supply** to be taxed at the GST rate which is applicable to fan.

Supply of software on CD and license to use same, could be liable to GST at rate applicable to software license[treated as service under GST] if agreement is for licensing of software.

Mixed Supply:

Section 2(74) “**mixed supply**” means two or more individual supplies of goods or services, or any combination thereof, made in conjunction with each other by a taxable person for a single price where such supply does not constitute a composite supply;

Mixed supply comprising two or more supplies shall be treated as supply of particular supply which attracts highest rate of tax. It shall not be a mixed supply if these items are supplied separately

Examples: A supply consisting of cakes and fresh fruits in single box, for a single price is a mixed supply. In such case where cakes are taxable and fruits exempted, each of these items can be supplied separately and is not dependent on any other. When supplied together, taxed at GST rate applicable to cakes.

Supply consisting of taxable coaching class and exempted residential dwelling, could be taxed at highest rate applicable to coaching class.

Bundled Services

Under service tax law, there is a concept of bundled service. When more than one type of service are provided in combination with each other in ordinary course of business, then such services to be treated based on essential character. Example, accommodation in hotel along with breakfast. Essential nature of service is that of hotel accommodation service and to be taxed at rate applicable to hotel accommodation service.

When more than one kind of service are not naturally bundled in the ordinary course of business, it shall be treated as provision of the single service which results in highest liability of service tax. Example, renting done for residential purpose along with renting for commercial purpose used as office. The residential dwelling used as residence is exempted from service tax and renting for office use is taxable. The entire is to be taxed at highest rate of tax of 15% applicable to renting for official use.

Importance of correct classification

Correct classification assumes great importance as tax liability essentially depends on effective rate of duty. An improper classification could have serious effect on business and relation with customer. Some of the possible ill effects are as under:

- a. There could be additional liability at later stage after correctly classifying and the taxable person could be saddled with huge demand from department and customer not willing to pay.
- b. Customer willing to pay tax [when received invoice/debit note within filing of next year Sept return] but not willing to pay interest and penalty.
- c. Missed out correct exemptions which were available if correct classification was done
- d. Transaction cost added by litigation.

Expectation in GST for classification of Goods

It is expected that the rules of interpretation which are essential for classification would be as per the Central Excise Tariff which is fairly developed in terms of judicial precedents. The principles of classification of goods and services under GST are set out in this article. We have examined the method to arrive at the appropriate classification or for professionals advise on the same as under:

- I. **Understanding of Business / Dictionary / Technological changes:** It is important to understand the nature of business, to determine the classification of the activities which are being taken by the company by referring to:
 - i. Company's website
 - ii. Technical Write-up
 - iii. Scientific / Technical terms / standards (Eg: Pharmacopia)
 - iv. Description of products given by sales and marketing team of company—especially the positioning of the goods/services,
 - v. Competitors classification
 - vi. Dictionary / Wikipedia:

- II. **Classification based on HSN:** HSN is an international practice of adopting a uniform classification was done to facilitate a common understanding of products across countries. HSN is a multi-purpose 8 digit product coding system for classifying goods. The HSN could be a good guide for confirming the understanding when in doubt. The Supreme Court has held in CCE v. Wood Craft Products Ltd. 1995 (77) E.L.T. 23 that HSN can be resorted to in case of ambiguity in classifying goods. The Honorable Supreme Court in the case of Phil Corporation Ltd 2008 (223) ELT 9 (SC) has held that HSN is a safe guide for classification.

III. What are the Rules for Interpretation?

There are interpretative rules provided for classification in HSN. These are called the General Interpretative Rules. Central Excise Tariff Act provides a similar set of six rules to act as an instrument for classification. These are used to determine applicable tax rate and coverage in exemption.

The classification should be first tested in the light of Rule 1 and if it is not possible, recourse is taken to rule 2, 3 and 4 in that same order in which the rules are set out.

1. Rule 1 provides that the titles of sections, chapters and sub-chapters are provided for ease of reference and determination of where the goods would fall and would be dependent on the relevant section and chapter notes contained in the Tariff. Example: The heading of Chapter 84 refer to nuclear reactors, machinery etc but even a hand pump falls under chapter 84. Where the Notes are silent, classification would be as per Note 2, 3, 4 and 5 of the Interpretative Rules. It would therefore be noted that Note 2, 3, 4 and 5 would have to be resorted to only if the Chapter does not contain any guide to classify the particular product. In the case of *Salora International Ltd Vs CCE 2012 (284) E.L.T. 3 (S.C.)* held that Tariff entries along with relevant Section and Chapter Notes, have to be resorted to first to see whether clear picture emerges. Only in absence of such a picture emerging, Interpretative Rules can be resorted to.
2. Rule 2(a) governs classification of incomplete or unfinished goods. It specifies that if the incomplete or unfinished goods have the essential characteristics of the complete or finished goods, then such goods would be classified in the same heading as the complete goods. Complete or finished goods would cover goods removed in unassembled or disassembled form. For instance a cycle removed in CKD condition is a 'cycle' or railway coaches removed without seats would still be railway coaches.
3. Rule 2(b) provides that any reference in a heading to a substance shall include mixtures or combinations of that material with other materials. Any reference to the goods of a given material or substance shall be taken to include a reference to goods consisting of such material or substance. However, classification would be according to Rule 3 in such cases, where the subject goods consists of more that one material or substance.

4. Rule 3 states that for the purposes of sub-rule (b) of rule 2 or where goods are prima facie classifiable under two headings, the following shall be done sequentially:
 - a. Specific description would have to be adopted in place of a general description. Example: Steering wheel of a car is part of motor vehicle as it is more specific. This was held by the Supreme Court in *Moorco India Ltd. v. CC*, 1994 (74) E.L.T. 003 (S.C).
 - b. When two or more headings each refer to part only of the materials or substances contained in mixed or composite goods or to part only of the items in a set, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete description of the goods. In such instances, classification has to be determined in terms of rule 3(b) or rule 3(c)
 - c. Mixtures, composite goods consisting of different materials shall be classified as if they consist of that material or part which gives them their essential character. Ex: Concrete mix mainly consists of cement, further small proportions of stone, water and chemicals, in terms of rule 3, the classification of concrete mix is made under articles of stone, plaster, cement as concrete mix consists mainly of cement.
 - d. Issue of essential character of subject matter in question as given in Rule 3(b) resorted to only if identification under Rule 3(a) providing for preference to more specific heading, is impossible. *CCE VsJOCIL Ltd* 2011 (263) E.L.T. 9 (S.C.)
 - e. When goods cannot be classified in a or b above, they shall be classified under that heading which occurs last in the numerical order among those which equally merit consideration.
5. Rule 4 says where goods cannot be classified using the above principles, they would be classified under the head appropriate to the goods to which they are most akin.
6. Rule 5: In respect of packing material which are specially designed or fitted to contain a specific article and given with the articles for which they are intended, shall follow the classification of the items which are packed. Ex: Camera cases, mobile cases, musical instrument case etc. such packing material if not used with the article for which it is intended for may have low or no utility. However this rule should not be adopted when packing material itself gives the essential character as a whole.

The packing materials and containers cleared or presented along with the goods are classifiable with the goods, however this provision would not be applicable when such packing

material are intended for its repetitive use. Ex: Glass bottles are meant for repetitive use and therefore cannot be classified along with soft drink.

7. Rule 6: While ascertaining the classification of goods in the sub-heading of a heading it should be determined according to the terms of those sub-headings and any related Sub-heading notes and, mutatis mutandis the above principles of classification on the understanding that only sub-headings at the same level are comparable. For the purposes of this rule, the relative Chapter and Section Notes apply, unless the context otherwise requires a different interpretation.

IV. Other Rules for Interpretation – Non-statutory Principles evolved out of Judicial decisions

Apart from the above statutory principles of classification, the Courts have evolved certain non-statutory principles. Some of these have been illustrated below. But it must be understood that statutory principles would have precedence over non-statutory principles. Some of the non-statutory principles for classification are:

- a. **Classification as per ISI/ Pharmacopeia etc:** Technology or complex chemical/ pharmaceutical products the reliance of the standard specified reference books can be done. However for common products this may not be relevant.
- b. **Trade parlance theory:** This is used when the words are not defined under the act and words are not used in scientific or technical sense in the tariff. Trade parlance means the meaning as commonly understood by the people dealing commercially with the subject goods or the commercial recognition that is given to a commodity. This aspect is at times ignored by the revenue departmental officials leading to litigation. This could be obtained from evidences led by the client whose product is being classified as well as how the product is classified by trade associations.
 - a. The terms in Tariff heading or sub-heading using commercial words to be interpreted as per trade understanding. In case of usage of strictly technical or scientific words, the approach should be different. *Chemical and Fibres of India Ltd. v UOI* [1997 (89) ELT 633 (SC)]

- c. **Function or use:** This principle is used when the definition in the statute is absent and articles are identified with their utility, primary use, design, shape etc. This refers to the primary function of the subject goods in the minds of the consumers of such goods.
- d. **Break up or constituent material:** Under this theory, the essential character of the product can be derived from the raw material that make up the goods.
- e. **Expert opinion:** Sometimes classification involving technical questions are decided after obtaining an opinion of experts and the opinion of the expert would not carry weight when they are contrary to another expert's opinion.
- f. **Dictionary meaning:** This principle can be adopted when the meaning given in the statute is overlapping, for finding out the trade understanding.
- g. **Decided case laws of High Courts and Supreme Court and advance rulings:** Such decisions where classification of goods was determined are also given weightage to arrive at the classification of goods.

V. **Other factors for determining classification of goods**

- a. **Raw materials classifications and rates:** It is essential to know the classification of raw materials and percentage of credit available and taken. When there is doubt on applicability of lower vs higher tax rate, advisable to pay at higher tax rate especially when the tax paid on inputs/raw materials is high leading to credit accumulation. The credit can be used to pay the output tax at higher rate.
- b. **Customer usage and credit whether available:** It is important to know what percentage of customer taking the credit. When there is doubt on applicability of lower vs higher tax rate, then could err on side of caution and pay at higher rate especially when customer being B2B is in position to avail credit.
- c. **New technology** products may require understanding the technological advances.

Services, classification could involve the following:

- a. **Terms of agreement:** The terms of agreement could be critical to find out what is the nature of the service.
- b. **Classification of independent service:** When service is independent service, then same to be classified in specific category. Example: outsourced advertising, market survey and other pre-sale services to be classified as business support service.
- c. **Bifurcation of combined service:** Examine whether the combined service can be bifurcated as per agreement/contract of service. Example: Exempted residential dwelling combined with taxable coaching class. When there is separate consideration for each service, could claim exemption for value of residential dwelling and tax to be paid on coaching class.
- d. **Essential character:** When combined service cannot be broken up, then classify based on essential character. Example: When some incidental logistics support service, such as post shipment tracking from US to India is done by commission agent engaged in enabling sale of goods of principal to Indian customers, the essential character is that of intermediary service, whose place of supply is India and liable to tax.

Care to be taken by professionals while classifying goods and services and claiming exemptions

- a. Entry has to be read in plain and simple terms. Do not make any assumptions and presumptions.
- b. The coverage of an entry has to be construed strictly.
- c. Even when the client claims coverage in any concessional rate of tax/exemption, the professional has to have skeptical view that the benefit may not be available. Then come to conclusion by following principles as set out above.
- d. For availing benefits under an exemption notification, the conditions have to be strictly complied with and met.
- e. Exemption Notification should be read literally and the same to be construed liberally if once it is found that notification is applicable to the assessee.
- f. When more than one exemption is available, assessee can opt for that notification which is more beneficial.

Suggestions for Govt.

1. Only 1 rate within 1 classification head to be ensured.
2. The Classification rules for goods could be exactly as per CET without any change.
3. The executive to be accountable for not responding to classifications adopted and intimated to them.
4. The rate of 28% needs to be only on 2% of goods and not at all for services.
5. Exemptions to be optional with the 5% rate being optional with credit.
6. The present attempt at keeping the rates the same as presently applicable is incorrect as that is the reason why evasion is taking place.
7. Even the high cesses on sin goods provide a premium for evasion. The present practice of part disclosure is expected to continue if the rates are going to be the same or more.

Conclusion

It has to be ensured that the classification of goods and services is done carefully. The danger of wrong classification is that the exemption is claimed/tax is paid at lower rate of say 5% against applicable 28%, which if comes to light at later point could wipe out the entire business.

When in doubt of the classification, confirmation in writing may be sought from the revenue by communicating by RPAD / by speed post. The law should provide that in case there is no reply within 6 months, the classification adopted is deemed to be ratified.

This article would need to be updated the moment the notification for the final rates/ exemptions are announced.

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