

Importance of Classification and Steps for classification - GST

GST is applicable on the taxable supplies of goods or service or both. However, certain provisions under GST Act and the rules made there under are applicable only with respect to goods and certain other provisions are applicable only to the services. Therefore, multiple rates could be applicable. It is important to classify a supply as supply of goods or supply of service.

In the GST law also, the classification of goods continues to be based on Customs Tariff Act, which is based on the HSN. The HSN based classification is further made applicable even for services. To understand the applicability of correct rate of GST or to determine whether any exemption is available, it is important to know the HSN code in which a particular goods or service is covered. Based on the HSN code, the GST rate, exemptions and conditions for exemptions, if any, are being notified.

Importance of classification

Department could object to the rate adopted or exemption claimed when mistake or error comes to light in the course of assessment, investigation or revenue audit. The customer may object to the classification or the rate. The assessee himself may come to know of the error due to competitors using different rates, paying or not paying, attending some awareness session, reading articles, books. Errors may also come to light at the time of due diligence, internal audit, statutory audit, outsourced consultant changing, etc.

Some assesseees would suffer loss of business in period of uncertainty till proper classification is arrived at as they may have stopped supplies for some time. Nobody could have got ready for the numerous rates and exemptions due to the fact that they were announced too late. A period of at least 6 months should have been provided for getting ready. However, those who got ready in May 2017 when list discussed in GST council was released were able to be better prepared and in case of unreasonable rates, represented and got the same corrected before 1st July.

Cost of mistakes in GST classification would include the following:

1. In case of higher tax charged, assessee may have to suffer the loss of orders and cost of re-establishing with the customers, the loss of credibility with customers. The cost of discounts is not factored which one is forced to give to retain the customer.

2. In case of goods or services supplied which are nil rated or exempted the denial of credit by the revenue up to 5 years can be fatal for the business.
3. In case of short charge due to incorrect classification or claim of exemption which is not available, would result in non-recoverability of taxes from the customers and cost of interest. In business, breaking the credit chain could make business unviable.
4. Valuation methods prescribed for certain categories of goods and or services would be dependent on the classification of such goods and/or services. Wrong classification would lead to wrong payment of tax.
5. On certain goods and/or services GST is to be discharged by the recipient of supply under reverse charge mechanism. Wrong classification may result in non-payment of tax or un-necessary payment of tax.
6. Denial of benefits under FTP such as duty drawback and incentives being provided for various goods and/or services at varied rates can be the result.
7. Non-payment of compensation Cess, if any, applicable on specified goods and or services which may result in penal proceedings
8. Getting the liability on Import of goods/Services all wrong or not claiming the ITC (Input Tax Credit) benefit of export on goods/service exports due to improper classification could also happen. This could happen when the alternative headings available have different import/export criterion being applicable to them.

In case of revenue raising the short charge or ineligible exemption issues, in addition to the above costs: the cost of penalty, denial of credit availed, cost of dispute resolution at adjudication, appeal, Court stages also would arise. It should be kept in mind that the internal manpower resources could get substantially involved to resolve the issue inspite of the fact that a specialist in GST maybe outsourced to prepare the reply, appearance etc.

Steps in Classification – A broad guideline

The supplier shall identify the correct classification of the goods as per the notifications issued under GST law and ascertain the rate of tax which is payable. The goods have to be primarily classified as per the description of the goods

specified therein and next as per the trade or commercial understanding of the product.

Understand the global scenario and then the Indian scenario of that business or activity, the alternative methods or variants, the domain knowledge of the transaction, Whether the GST paid is available as ITC and the customer profile. A brief study including web search for images.

The steps involved for classification of goods are as follows.

1. The first step is to find out the classification heading based on the description and nature of the goods being supplied as per the notified rate schedule. Confirm that the product is also similarly or more specifically covered in the Customs Tariff and HSN 2017. The Section Notes and Chapter Notes to the Schedule to be read.
2. If there is no ambiguity, the classification is final and there is no need to apply the non-statutory principles of classifications set out in commentary section above.
3. If there is ambiguity, first reference shall be made to the Rules for interpretation of the Customs Tariff. Find the trade understanding of the terms used in the Schedule, if the meaning is not clear. If the trade understanding is not available, the next step is to refer to the technical or scientific meaning of the term. If the tariff headings have technical or scientific meanings, then that has to be ascertained first before the test of trade understanding. If none of the above are available reference may be had to the dictionary meaning or ISI specifications. Evidence may be gathered on end use or predominant use.
4. In case of the unfinished or incomplete goods, ascertain if the unfinished product has the essential characteristics of the finished product, if yes; apply that classification to the unfinished product.
5. If the classification is not ascertained as per point (e) mentioned above, find out the heading, which is more specific to the nature of product.
6. If the classification is still elusive, ascertain which material gives the article its essential characteristics and use that classification.
7. While doing so, consideration as to the following non-statutory principles can also applied for classification, however it should be understood that statutory principles shall have precedence over non-statutory principles.

8. Find the trade understanding of the terms if the meaning is not clear.
9. If the trade understanding is not available, the next step is to refer to the technical or scientific meaning. However if the tariff headings have technical or scientific meanings, then that has to be ascertained first before the test of trade understanding. If none of the above is available, reference may be made to the dictionary meaning or ISI specifications. Evidence may be gathered on end use or predominant use.
10. Once the goods are appropriately classified, then examine whether any exemption or concessional notification exists. Here care is to be taken to ensure conditions if any are complied with/compliable in full or substantially.
11. It is suggested to classify and to declare all the goods supplied including by-products, intermediate products, stock transfers, job work, waste and scrap, if any generated during the manufacturing process. (Exempted items are also to be declared as an additional disclosure as a measure of caution)
12. The supplier should as far as possible, provide the description of the goods as it is to be invoiced or as it is understood in the market (including brand name, if any). It would be advisable to enclose trade literature. The HSN description need not be reproduced. For example, the spindle assembly is basically a part of wiper for cars. Instead of declaring the same as 'Parts of Wiper', declare the same as 'Spindle Assembly for Wipers of Cars.'

It is possible that the rate arrived at is higher than what others in organized/unorganized trade/industry are using. Also that there is a doubt. In such cases, till clarity emerges, the additional action points could be as under:

- (a) Represent truthfully background that specifies of the goods seeking, conformity fairness equality, pouncing reasons for rate sought. This needs to be made to the GST council as well as all the State GST Commissioners.
- (b) Simultaneously one could go through the association which represent many.
- (c) Go for an advance ruling. If satisfied with finding all right, if not go for appeal.

The following steps may be followed while classifying the services;

1. The first step is to determine and confirm whether it is a supply of service.

2. If more than one item viz. goods and/or services are being supplied together, determine whether it is a composite supply or mixed supply.
3. In case of composite supply, identify the principal supply and decide whether it is supply of goods or supply of service.
4. Verify whether it is a mixed supply. Identify the different supplies in the mixed supply and classify all the supplies involved.
5. Refer to Schedule II to the CGST Act, 2017 to confirm whether the supply is a deemed service.
6. Refer the exemption Notification No. 12/2017-Central Tax (Rate), dated 28.06.2017, to decide whether a particular service is exempt or not. The classification under HSN is irrelevant in deciding the exemption since the exemption is based on the description of the service and not on the basis of classification under HSN. Nonetheless, the classification of exempt service is required to be mentioned in the invoice, returns and records.
7. Find out the classification heading based on the description and nature of the service being supplied in the notification 11/2017-Central Tax (Rate) dated 28/6/2017 – amended time to time and determine the four digit classification heading.
8. Determine the rate of GST by referring to the said relevant notification.

Further CBEC has released mobile application for determining the classification of goods and/services called as “GST Rate finder” which could be used for indications but may not be conclusive.

Conclusion:

It is said that a stitch in time saves nine - an old English proverb. It is and a business fact that cost of prevention is negligible against the cost of a cure. The time involved in seeking clarity later or resolving the dispute could be used more productively for doing business. Further, the tax department (adjudication, appeal), the Tribunals and Courts are clogged with old disputes and in India are a major reform area being focused by Government. Their time and effort for a non-productive activity is a loss to the nation.

This article is adapted from the Book on Classification & Exemption in GST to be published in November 2017 authored by CA Madhukar N Hiregange, CA Vasant Bhat & CA Nagendra Hegde.