Principles of Classification

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Under indirect tax laws, classification is the categorization of goods and services crucial to ascertain whether a subject matter is eligible to tax, exemption, rate of tax etc. Classification of goods or services is a complex procedure of ascertaining whether goods or services are composite, non-composite or mixed, and how to resolve competitive entries. In this article we can learn about principles of classification.

1. Introduction

The term classification implies arrangement according to classes or types. The scheme of indirect taxation requires the classification of goods/services under the various headings provided under these laws to determine whether or not the same would be encumbered by the levy of these taxes and if so, under which heading the duty liability would accrue.

In the case of GST legislations, similar to other indirect tax laws, classification is given a detailed enunciation within the legislative framework. There are elaborate statutorily stipulated rules to determine whether the supply concerned is a supply of "goods" or "services" and thereafter classify such goods or services within the rate schedule (also known as "tariff") to ascertain their tax ability and, if so, the applicable rate of tax on such supply.

2. Goods

Section 2(22) of **Customs Act, 1962** defines as under:

"Goods" include includes-

(a) Vessels, aircrafts and vehicles;

(b) Stores;

(c) Currency and negotiable instruments; and

(d) Any other kind of movable property;

Or

Section 2(52), of **GST Act**, states that "goods means every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply".

Or

Article 366 (12) of the **Indian Constitution** defines goods as "Goods includes all materials, commodities and articles."

3. Sales tax and VAT

The imposition of tax on the sale of goods is essentially in the nature of a trade tax, being an indirect tax. The levy is upon the incidence of sale of goods. For the purpose of imposition of the levy, the various goods have been segregated into various headings.

The above levy comprises of two limbs, i.e. Central Sales Tax and State Sales Tax. Central Sales Tax is levied upon sales spanning between two states or interstate sales while state sales tax encumbers sales effected within the state. The legislation regarding State sales tax received a makeover when the VAT Acts were introduced replacing the old State Sales Tax Acts.

4. Central Excise and Customs

Section 37B of the **Central Excise Act, 1944** empowers the central board of excise and customs to issue orders, instructions and directions, for the purpose of uniformity in the classification of goods or with respect to the levy of excise duties on such goods.

Central excise tariff is based on the Harmonized system of Nomenclature (HSN). When there is no ambiguity about the scope of the entry, the classification is to be done as per the entry in the tariff itself. HSN explanatory notes can be resorted to in the case of ambiguity in classifying goods.

It is pertinent to that the both the central excise and customs tariffs contain general principles for the interpretation of the tariff. The said rules are:

Rule 1 States that the titles of sections, chapters and sub-chapters are provided for ease of reference and determination of where the goods fall will be dependent on the relevant section and chapter notes contained in the tariff. Therefore, headings are not determinative of classification.

Rule 2(a) States that an article referred to in the schedule would be said to include the same when it is incomplete or unfinished if it has the essential character of the complete or unfinished article. It would include therefore articles presented in unassembled form.

Rule 2(b) States that a heading referring to a material or substance shall be taken to include a reference to mixtures or combinations of that material or substance with other materials or substances.

Rule 3 provides for circumstances where the goods seem to be classifiable under more than one heading and provides as follows:

(a) The heading which provides the most specific description shall be preferred to headings providing a more general description. However, 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 put up for a retail sale, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete or precise description of the goods.

(b) Mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale, which cannot be classified by reference to (a), shall be classified as if they consisted of the material or component which

gives them their essential character, insofar as this criterion is applicable.

(c) When goods cannot be classified by reference to (a) or (b), they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.

In **Akbar Badruddin Jaiwani vs. CC 1990 (47) ELT 161 (SC)**, the supreme court was faced with the question whether marble was a polishable calcareous stone. While holding that the slabs of calcareous stone imported by the appellant were not marble as mentioned in entry no. 62 of Appendix 2 of the Import and Export policy for April 1988-March 1991 and so was covered by open general license, it was also held that the express wordings of the Tariff Headings and relevant Section and chapter notes would take precedence over the commercial or trade parlance test for classifying excisable goods. However if the specific headings and notes do not cover the excisable goods, then resort must be had to the commercial or trade understanding of the goods.

In the case of CCE, Bhubaneswar vs. Champdany Industries ltd. 2009 (241) ELT 481 (SC), the supreme court, while holding that multi-fabric carpets in which jute was the predominant material used were classifiable as jute carpets, stated that the dominant intention of the rules was to classify goods under heading which provided most specific description than the one providing general description. The interpretative rules were held to be inapplicable when the section and chapter notes provided clarity on classification.

5. Common/Commercial Parlance

As stated earlier, common parlance test is used in the absence of any statutory guideline.

The high court of Bombay in the case of **CST vs. Dev Enterprises ltd. (2011) 42 VST 504 (Bom)** while holding that footwear was classifiable under residual Entry E-1 and liable to

tax at 12.5%, noted the decision in A. **Nagaraju Bros vs. State of Andhra Pradesh (1994) 95 STC 1 (SC)** as follows:

"The Supreme Court noted that there was no single or universal test to be applied and it is for this reason probably that the common parlance test or commercial usage test is treated as a more appropriate test, though, not the only one. The court held that there may be cases, particularly in the case of new products, where this test may not be appropriate, in such cases, other tests like the test of predominance, either by weight or value or on some other basis may have to be applied.

6. Dictionary Meaning

In the case of **Collector of Central Excise, Kanpur vs. Krishna Carbon Paper Co. 1988 (37) ELT 480 (SC)** while answering the questions whether carbon papers could be included in "all kinds of paper including the paper which have been subjected to coating" during the relevant period in the affirmative, the Supreme court observed that:

"It is well-settled that in order to ascertain the correct meaning of a fiscal entry reference to a dictionary is apt to be a somewhat delusive guide, as it gives all the different shades of meaning".

The Supreme Court observed that reference to a dictionary meaning is not safe when there is no definition in the statue for ascertaining the meaning of tariff entry. The correct guide would be parlance. Where either of the two is not possible then the meaning following from the statue at a particular point of time would be a decisive test. In other cases where no evidence is available other than the ISI specifications, these should be relied upon for interpreting a Tariff entry.

7. Expert Opinion

In the case of **CCE vs. J.L. Morison 1986 (25) ELT 660 (Kar)**, the question was whether the local anaesthetic manufactured by the Respondent without using alcohol falls within item 1(iii) of the Schedule to the medicinal and Toilet preparations (Excise

Duties) Act, 1955 or under item 14E of the Central Excise Tariff and, therefore, stood excluded from item 1(iii) of the Act. It was observed that classifications of goods involving technical questions are not decide-able without technical option.

8. End Use

In **Indian Aluminium Cables ltd. vs. UOI (21) ELT 3 (SC)** it was held that process of manufacture and end use to which it is put, cannot necessarily be determinative of classification of that product under fiscal statute like CETA. What is more important is that whether the broad description of the article fits in the expression used in the tariff.

Therefore, it appears that predominantly, the end user test would not be used as a first principle and would come in last if there is no other test or the tariff entry itself is based on end use.

9. HSN & ISI Technology

The Supreme Court was held in **CCE vs. Wood Craft Products ltd. 1995 (77) ELT 23 (SC)**, while holding that blocks boards were classifiable under heading 44.08 under the expression similar lamented wood, observed that HSN can be resorted to in case of ambiguity in classifying goods. The use of HSN must be preferred over the ISI terminology.

Therefore, the principle is that HSN would apply where the tariff is aligned along HSN, otherwise the entries have to be interpreted on their own strength.

10. Search of HSN Code

Chapter note of Tariff Heading are specified in GST Tariff ACT. For the purpose of classification a example of Textile & Textile Article (Section XI) wide Chapter Note 2 are reproduced below:

A) Goods classifiable in chapters 50 to 55 or in heading 5809 or 5902 and of a mixture of two or more textile materials are to be classified as if consisting wholly of that one textile material which predominates by weight over any other single textile material.

When no one textile material predominates by weight, the goods are to be classified as if consisting wholly of that one textile material which is covered by the heading which occurs last in numerical order among those which equally merit consideration.

B) For the purpose of the above rule:

(a) gimped horsehair yarn (heading 5110) and metallised yarn (heading 5605) are to be treated as a single textile material the weight of which is to be taken as the aggregate of the weights of its components; for the classification of woven fabrics, metal thread is to be regarded as a textile material;

(b) The choice of appropriate heading shall be effected by determining first the chapter and then the applicable heading within the chapter, disregarding any materials not classified in that chapter-

(c) When both chapters 54 and 55 are involved with any other chapter, chapters 54 and 55 are to be treated as a single chapter;

(d) Where a chapter or a heading refers to goods of different textile materials, such materials are to be treated as a single textile material.

C) The provisions of paragraphs (a) and (b) above apply also to the yarns referred to in Note3, 4, 5 or 6.

11. Imperative Notes (Rules) to Central Excise Tariff

The Central Excise Tariff Act, 1985, contains a set of five general rules for the interpretation of the Tariff schedule. By and large, these rules for interpretation are identical to those contained in the HSN. Accordingly, the Explanatory Notes issued for these interpretative rules under HSN are also relevant for central excise purpose.

12. Specific Entries Exclude General Entries

Specific entries will have to be adopted in place of a general description. This has been adopted by the Supreme Court in

Moorco India ltd. vs. Cc 1994 (74) ELT 5 (SC) wherein it was held that Flow meter specifically is classified in heading no. 90.24, whereas the heading 90.26 is general in nature. It applies to every production meter or calibrating meter for gas, liquid and electricity supply.

Therefore, the principle that specific heading overrides a general heading is well established in tax statutes. It is also well established that residuary heading can be resorted to if even after a liberal interpretation, the item cannot be confined to the specific heading.

13. Long Standing Classification (Head 1)

In the case of **Pharm Aromatic Chemicals vs. Municipal Corp. of Greater Bombay 1997 (95) ELT 203 (Bom)** it was held that:

Tolu balsam is primarily used as cough expectorant or tincture though it can also be used as a flavouring agent in shampoos, chocolates etc. The admitted position is that the petitioner is a dealer in drugs. He has imported Balsam Tolu B.P. from England. It is of the British pharmacopoeia grade. All these clearly go to show that it is intended to be used as pharmaceutical item. Considering all these factors, it is abundantly clear that in commercial or trade parlance Balsam Tolu is known as a drug. Its primary and dominant use is also pharmaceutical. 'Balsam Syrup' and 'Balsam Tincture' appear to be well known Balsam preparations. In the premises, the BMC had correctly interpreted this item all throughout in the past as a drug. There is no justification for deviating from this interpretation.

The following principles of classification are relied upon:

a) Classification of goods followed by the department for a number of years cannot be departed from unless new material or cogent reasons are available for changing classification.

b) The common parlance principle.

c) Classification can be based on end use of a product.

Therefore, the principle is that while revenue can re-open a classification, it is incumbent on them to prove with new material why a long standing classification should be disturbed.

14. <u>Rules for interpretation - Non-statutory principles</u>

In **CCE vs. Wood Polymers ltd. 1998 (97) ELT 193 (SC)**, their lordships of the Supreme Court held that Rules of interpretation will be preferred to the common parlance test.

In **Commissioner of Trade Tax, Uttar Pradesh vs. S.S. Ayodhya Distillery and Others (2009) 19 VST 251 (SC)**, while holding that for the purpose of determining the rate of tax prescribed by various notifications issued under the U.P. Trade Tax Act, 1948 rice husk and paddy husk have to be treated as different commodities, it was observed that if something is included in the schedule which is non-existent, no tax can be levied thereupon. Furthermore, if there is a doubt or dispute as to whether paddy husk or the rice husk denotes the same commodity or not, the benefit thereof shall be given to the assessee.

15. <u>Burden of Proof</u>

In **CCE vs. Calcutta steel Industries 1989 (39) ELT 175 (SC)**, it was held that if the department wants to tax particular goods known as such then the onus is on the department. It was held that rectangular products of iron and steel flat product of thickness less than 3.00 mm and width of less than 75 mm were classifiable as bars under Tariff Item 26AA(ia) and not as hoops under item 25AA(ii) of the Central Excise Tariff.

In **Ponds India Ltd (Merged with H.L. Ltd) vs. Commissioner of Trade Tax, Lucknow 2008 (65) Kar L.J. 342 (SC)**, it was held that where report of chemical examiner is in favour of assessee and Revenue itself has been holding assessee to be a manufacturer of pharmaceutical products, burden is on revenue to establish that “petroleum jelly” falling under relevant entry is taxable as “cosmetic”.

16. Services

Section 2(102) of **GST Act** defines services as:

It means anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.

Section 65A dealt with 'Classification of taxable services', sub-section (1) of which, provides that for the purposes of service tax provisions, classification of taxable services shall be determined according to the terms of the sub-clauses (105) of section 65 which stipulates the definitions of various taxable services. The said section reads as under:-

1) For the purposes of this chapter, classification of taxable services shall be determined according to the terms of the sub-clauses of clause (105) of section 65.

2) When for any reason, a taxable service is, prima facie, classifiable under two or more sub-clauses of clause (105) of section 65, classification shall be effected as follows:-

a) The sub-clause which provides the most specific description shall be preferred to sub-clauses providing a more general description;

b) Composite services consisting of a combination of different services which cannot be classified in the manner specified in clause (a), shall be classified as if they consisted of a service which gives them their essential character, insofar as this criterion is applicable;

c) When a service cannot be classified in the manner specified ion the clause (a) or clause (b), it shall be classified under the sub-clause which occurs first among the sub-clauses which equally merit consideration.

There are two important points to remember when we compare central excise/customs tariff classification principles and service tax:

a) When two headings apply equally, in central excise and customs the heading which comes last is preferred. For example, if chapter 84 and 85 are equally attracted, chapter 85 will be where the product is classified. In service tax however, there is no HSN. The classification would be done based on the earliest entry rather than the latest entry - this is to ensure that it is taxed from an earlier period.

b) Section 65A would not apply where the taxable services itself excludes the application the of Section 65A. For example, port services.

In the case of **Ramakrishna Reddy vs. CCE 2009 (13) STR 661**, the Tribunal has taken a view that where the appellant was engaged in the activity in relation to mining, the activities of removal of overburden and excavation were held to be incidental to mining and since the essential character of the service was that of mining, it would not be taxable under site formation service.

After 1 July 2012, Section 66F would deal with classification of services including bundled services. The main principles would be:

a. Reference to a service would not include service used to provide the main service.

b. Specific description would prevail over general description;

c. where services are bundled,

i. If they are naturally bundled, it shall be treated as that single service based on the essential character principle;

ii. If they are not naturally bundled, it shall be classified under that heading which has highest tax liability;

17. Conclusion

That classification of goods is not easy can be gauged from the fact that there are over 5000 tariff headings what to say of tariff entries. Furthermore, owing to economic, political or other reasons of fiscal policy, there are frequent amendments in the rate schedule which require realignment and revalidation of the classification hitherto adopted. The same holds true for classification of services. It is therefore essential while undertaking classification that one is precisely aware of the relevant considerations and principles attendant to the classification exercise, be it goods or services.

Please give your Respective feedback

Warm Regards

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