Research Paper

Classification of Services across the World and in India

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ABSTRACT: *In this paper, the authors review the system of classification of services followed across the world. Classification of services for the purpose of economic statistics or trade differs from the classification of services for the purpose of taxation. Taking the Indian case, the authors explain how a system of classification of services has emerged over a period of time, as the tax on services was gradually extended since 1994. Instead of designing a classification in a comprehensive manner based on defined a set of principles, if tax authorities let the classification evolve, many consequences follow, few of which are discussed by the officers.*
Keywords: taxation, tax on services, classification of services, Goods and Services Tax, Indirect tax

I.   INTRODUCTION

The purpose of classification is to provide a clear and practical way to organize and communicate information. Classification helps in analytical research since based on certain set of principles, items with similarities are grouped together vis-à-vis those with dissimilarities. In other words, classification reflects the diversity of the research universe. In addition, classification provides a way to establish a link between related items arranged in an Order. Group arrangement of items based on principles enables the making of a hypothetical relationship between different items, frequently referred as variables. Though Carl Linnaeus is known as the father of taxonomy, for having introduced the classification of biological organisms based on the 'binomial nomenclature' [genus name and species name], it was Aristotle, who laid the foundation of analytical research using classification, when he classified creatures into 'animals with blood vs animals without blood' and 'animals that live on land vs animals that live on water'. In his seminal work, 'History of Animals', he sowed the seeds of binomial classification, based on the principle of 'ladder of nature' or a 'Great chain of being'. Beginning with Aristotle, now, 'classification' as a method, has permeated almost every academic discipline of research.

In this paper, various systems of classification of services, followed across the world. I'll examine, how the purpose of classification, gives rise to principles, based on which services are classified. The purpose of classification can be anything, including generation of economic statistics(UN-CPC), expansion of trade(WTO) or taxation (Indian scenario). In the Indian scenario, for the purpose of levy of service tax, historical development of tax base itself, is offered as a classification principle and known as 'positive list'.

II. CLASSIFICATION OF SERVICES - INTERNATIONAL SCENARIO
2.1 United Nations Central Product Classification (CPC) version 2.1

2.1.1 Outcome of production, made by human beings, involving intellect, machinery and other resources, takes two forms, as goods or services. Goods are tangible, transportable and storable. In a five-digit classification, the United Nations Central Product Classification tries to classify all the goods and services, which human beings produce. In the classification of products provided by the UN-CPC, there are three advantages: (i) such a classification goods and services helps in comparison of specific activities across countries, particularly economies; (ii) various types of statistics used in different parts of the world can be harmonized in the long run, which means reliable statistics can be generated; (iii) the classification of goods and services developed by UN can be used as a standard, to measure, how other classification or statistical systems are comprehensive in their coverage.

2.1.2 Under CPC, goods and services are subdivided into a hierarchical, five-level structure. The classification is made of categories designed to be mutually exclusive. Sections are the highest-level categories. Sections are enumerated. Some examples of sections are, "Agriculture, forestry and fishery products" (section 0), "Constructions and construction services" (section 5) or "Community, social and personal services" (section **9).** The classification is then organized into numerically coded more detailed categories: two-digit divisions; three-digit groups; four-digit classes; and, at the greatest level of detail, five-digit subclasses.

Goods and services which arise from a single industry are grouped together, in the classification. Goods in the harmonized system (HS) are classified in sections 0-4 and the in sections 5-9.

2.1.3. It is not possible to segregate goods and services in the real world. Many a times goods come along with services and services are provided involving some goods. Therefore, a category of 'other products' are found in CPC. For example, intellectual property products are classified as other products.

2.1.4 CPC classifications is based on certain principles[1], which are as follows:
(**a**) category that provides the most specific descriptions shall be preferred to categories providing a more general description;
(**b**) composite services (meaning, a combination of different services) which cannot be classified on the basis of principle (a), should be classified as if they consisted of the service which gives them their essential character, in so far as this criterion is applicable;
(**c**) When services cannot be classified based on the principle at (a) or (b), classification should be under the category that occurs last in numerical order among those equally merit consideration;
(**d**) if a service is not classifiable based on the above principles, they should be classified under the category appropriate to the services to which they are akin;
(**e**) in case of bundle of goods and services, classification shall be according to their main component, in terms of value addition, in so far as the criterion is applicable.

2.1.5In the UNCPC, when a description of services falls under two or more categories, classification should be decided at the level of same categories, like for example sections, divisions, groups, classes or subclasses that are comparable. An overlap occurring at the level of divisions should not be decided at the level of groups. UN CPC is also supported by very extensive Explanatory Notes. Countries across the world, adapt the UN-CPC to suit their local requirements. In India, the National Statistical Organization, has been involved in the designing of national version of the CPC.

2.2WTO Services Sectoral Classification List: W/120

2.2.1 According to the General Agreement on Trade in Services (GATS), trade in services is nothing but supply of services. There are four modes of such supply of service, namely, cross-border supply, consumption abroad, commercial presence and the presence of natural persons. WTO Members are not obliged to use any particular classification system in undertaking commitments regarding trade in services. The Services Sectoral Classification List (W/120), designed as an informal document for the services negotiation in 1991, Uruguay Round, is used as the principal guiding classification system in several trade negotiations across the world.

2.2.2The Services Sectoral Classification List consists of eleven broad sectors. The description "Other Services Not Included Elsewhere", serves as a residual category. With the arrival of 'new services' in the field of telecommunications, computer, logistics and education services, overlap between descriptions used in the sectoral classification has become a challenge to be resolved.

III. CLASSIFICATION OF SERVICES FOR ECONOMIC STATISTICS – INDIAN SCENARIO

3.1National Product Classification for Services Sector(NPCSS)

3.1.1 Central Statistics Office (CSO) of the National Statistical Organization under the Indian Ministry of Statistics & Programme Implementation brought out a National Product Classification for Services Sector (NPCSS).

3.1.2As per the recommendations of the Expert Committee for Standardization and Mapping of National Product Classification (NIC) and Indian Trade Classification [ITC (HS)], the Central Statistics Office (CSO) of the NSO developed the draft Product Classification for the non-transportable goods (Services). The Services sector covers the areas of Constructions & Construction services, Distributive trade services; accommodation, food and beverage serving services; transport services; and electricity, gas and water distribution services, Financial and related services; real estate services, and rental and leasing services, Business and Production services, Community, social and Personal Services.

3.1.3 The ITC (HS) contains 97 chapters in accordance with the Harmonized System Nomenclature (HS), developed by World Customs Organization (WCO). The chapters 98 and 99 which are reserved for individual countries by WCO are used in India for the purposes of 'Project imports' and 'Miscellaneous goods' respectively. To maintain continuity of the classification of services sector along with the classification of transportable goods, in consultation with DGCI&S (which is the custodian of ITC (HS)), the Product Classification for services sector was developed under the chapter 99. Further, under the chapter 99, the next five digits were adopted from the Central Product Classification (CPC), which is a five-digited Product classification developed by United Nations Statistics Division (UNSD) for both transportable goods and non-

transportable goods. To maintain the number of digits as eight, as is the case in ITC, and to expand the CPC five digit codes further according to the Indian requirements, each CPC subclass (5 digited) has been classified into maximum nine categories to arrive at an ultimate eight-digit product code.

3.1.4 Thus, the structure of the National Product Classification for Services Sector (NPCSS) may be described as "99 + five-digited CPC code + one digit for Indian requirements". The main advantages of this eight-digit coding structure are the continuation with the existing ITC and the international comparability (since Customs and Central Excise Tariff, which is based on the HSN developed by the WCO, is also an eight-digit classification system for commodities). Essentially, NPCSS is based on UN-CPC. Therefore, Interpretative Rules for Classification and Explanatory Notes, which support the UN-CPC should also be applicable to NPCSS.

IV. CLASSIFICATION OF SERVICES FOR TAXATION – CURRENT PRACTICE IN INDIA

4.1When services were taxed for the first time, in the year 1994 under Chapter V of the Finance Act, 1994, need for a classification did not arise. It was in the year 2003, after the expansion of tax base to cover more services, section 65A was inserted in Chapter V of the Finance Act, 1994, which outlined the principles of classification. A need for such a classification of services arose for several reasons: firstly, to ensure registration of the service provider in the appropriate category; secondly, to ascertain the date of commencement of taxability; thirdly, to know the rate of applicable service tax; fourthly, to determine the right to claim exemptions, abatements, CENVAT credit and rebates appropriately.

4.2 Section 65A which specified the principle governing the classification of taxable services, codified the norm that a more specific description must override the less specific one and that in the case of composite services, the service must be classified in accordance with its essential character. Moreover, 65A contained a residuary clause which stated that where the aforementioned provisions cannot be applied, the service must be classified under the category that appears first in the numerical order. The actual administration of Section 65A, over a period of time, relied on various ad hoc ruling of courts, on classification. Section 65A was replaced by the concept of bundling, in the year 2012, which provided principles for classification of mixed services and composite services.

4.3Under the positive list approach to taxation of services being followed in India for more than twenty years now, services were taxed at a uniform rate theoretically; but value of the taxable service was adjusted by way of statutory abatements on which uniform tax rate was applied. In Harmonized System of Classification for goods, maintained by the World Customs Organization, now followed all over the world for levy of Customs duty, the classification is mainly used for levy of differential rate of duty. But in the case of services, classification has not been used for differential levy. Services being intangible and many a times available along with goods, disputes will be innumerable. "Criteria for distinction of similar items with different rates are not found easily" [2]. Even in the case of goods, countries trying to reduce the number of rates, so that legal disputes on correct classification can be minimized.

4.4 In the Indian scenario, as the taxable services increased in number, with each passing year, accounting codes for revenue collection which were allotted by the Comptroller & Auditor General of India(C&AG), came to be used for identifying the taxable services read with other definitions in section 65(105) of the Finance Act, 1994. When the new approach to taxation of services (based on the negative list) came to be introduced in the year 2012, as a preparation for introduction of Goods and services Tax (GST), there were 119 taxable services, for which 476 (119 X 4) accounting codes were available in all, to monitor the payment of service tax, penalty, other payments including interests and deduct refund. In the accounting code system, 0044- the first four digit of the code specifies 'tax on services' and the next four digits mark the particular taxable service.

4.5 The organization of accounting codes in the positive list of taxation was based on the seriatim of extension of levy on various services. Though section 65A, ceased to be operational from 1st July 2012 (with the introduction of negative list based levy), vide circular No. 165/16/2012-ST dated 20.11.2012, descriptions of the positivist list of taxable services and the corresponding accounting codes were continued, along with a residuary entry " Other taxable services", for the purpose of registration and payment of service tax.

4.6Accounting code based classification(SAC)in services, has given rise to many problems and issues: (i) the codes for tax/interest(other)/penalties/deduct from refunds do not follow any logic since it was allotted for accounting the revenue collections, by the C&AG, on need basis; (ii) over the years, no systematic method for expansion of the tax base has been adopted, though it is evident that some of the descriptions of services have been borrowed from international standards of classification pertaining to activity and products; (iii) the descriptions of services given to represent each accounting codes, reflects a policy dilemma between old and new approach to taxation of services; (iv) the absence of a logical scheme of classification and categorization of services has resulted in proliferation of errors and innumerable legal disputes; (v) similar services brought under

tax net at different point of time led to dispute over the taxability, effective date of levy, applicability of abatement from taxable value/tax exemption, etc.; (vi) the expansion of tax base under the positive list approach was not sectoral, therefore the codes seriatim are also not sector – wise;(vii) related service of a particular sub-sector does not have a sub-code and gets covered under the Business Auxiliary Service, which is not a sector by itself. Though Business Auxiliary Service or Business Support service was defined in the statute on taxation of services, it was more used as a residual category to classify services not classifiable elsewhere; (viii) classification principles similar to that of the international classification systems were super imposed on locally made definitions of taxable services, which were overlapping and hence led to legal disputes before the tribunals and courts. International classification systems use descriptions of services for hierarchical arrangement but not definitions.

 4.7 Even though the negative list based levy largely obviates the need for description of services, descriptions continue to exist in certain areas such as section 66D of the Finance Act,1994 - Negative list of services, section 66E - Declared list of services, Rule 2A, 2B and 2C of Valuation Rules, 2006, Rule 6 of Service Tax Rules, 1994, mega exemption notification no. 25/2012-ST dated 20.06.2012, abatement notification - 26/2012-ST dated 20.06.2012, reverse charge mechanism - Rule 2(1)(d) of Service Tax Rules, 1994 read with Notification No. 30/2012-ST dated 20.06.2012; place of provision of service Rules, 2012 and Cenvat Credit Rules, 2004. The absence of a proper scheme of classification code has extended legal disputes into the negative list regime as well.

V. SERVICES - FUTURE OF CLASSIFICATION IN THE CONTEXT OF GST

 5.1Services Accounting Codes (SAC) is against the very principle of GST, since at the point of payment of tax, it insists on classification. For an ideal GST, generally classification of goods and services is not required, since rate will be uniform on the broadest possible tax base. When classification is 'referred to' in the GST parlance, it refers to classification of goods and services, since, (i) for the purpose of differentiating goods and services, and (ii) in the case of services, 'place of consumption' needs to be identified, by a special set of Rules. Goods have to be necessarily distinguished from services, since in all VAT/GST systems, separate rules exist for determination of the place of consumption in services.

 5.2 Present system of services accounting code (SAC) based classification, does not have any legal backing, in service tax law. However, it insists on correct classification at the point of payment of tax. This poses a serious challenge to the compliance and ease of doing business. Wrong accounting code in the tax payment challan implies the wrong classification as well or even a misdeclaration of service provided or received. If an accounting code is mentioned wrongly, by a service tax payer, when the payment is made, a person may not easily get a refund or adjustment. Correction of the wrong accounting code becomes next to impossible, without a refundand re-payment. In effect, under the guise of accounting codes, the present system of classification is actually, managed by the banks, at the point of payment of service tax. Taxpayer has to choose from the description of services listed under the accounting codes at the time registration, which continues to be in use for payment of tax and filing of Return. If a proper description is not available under the accounting codes, taxpayer has to opt for residual category, which results in clubbing. Due to clubbing, the present system of accounting codes hampers even a reliable statistical analysis of tax collections.

 5.3 For compliance purposes, it is mandatory that the taxpayer should correctly mention the accounting code, at the time of payment of tax, in the tax payment challan. Thus, compared to duty payment in the case of Customs or Central Excise, tax payment in the case of service tax, is tedious and onerous, for a taxpayer. While making Central Excise duty payment through a bank challan, a taxpayer is not expected to classify the goods or even mention the specific commodity description; but in contrast a service taxpayer, at the point of payment of service tax is expected to specify the correct accounting code of the taxable service towards which payment is being made. Similarly, while paying customs duty in the bank challan, classification of the imported goods is irrelevant. But in the case of services, at the point of payment of duty, correct classification is most important, since tax payment codes actually implies an exercise of a conscious choice of classification from among different services (though such choice of correct classification, is not legally required). In the accounting code based classification of services, there is a hidden presumption that reliable data on tax payment can be obtained only at the point of payment of tax, through the banks, which calls for critical scrutiny. Refunds arising from service tax payments under incorrect accounting codes, and re-payments under correct codes are not taken into account, for the purpose of statistical analysis.

 5.4Under GST, if services accounting code based classification will be used, there may be a rapid proliferation of accounting codes, making service tax payment, very tedious for the taxpayer. Since CGST, SGST and IGST needs to be captured separately, for each service, there will be 9 codes, and altogether, 120x9 will be 1080 codes. Even after this, under the residual code, namely "all other services" (other than the 119), the clubbing will be substantial, for which it may not be possible to get sufficient sectoral data for analysis.

Considering the fact that GST will be collected on a much broader tax base, than it is today, there will be a need to know, the services which go into the 'residual category'.

5.5Making classification mandatory at the point of payment of tax, while presenting the tax payment challan in the bank, is unique to India, not found in any other part of the world. Classification, can be in the invoice or in the Returns but certainly not in the tax payment challan, presented in the bank for debiting the service tax from the taxpayer's account. Since GST is for lowering taxes (because it is levied on a broader tax base) and simplification of compliance (by elimination of classifications), classification at the point of payment of tax, based on accounting code, would directly hamper the efficient operation of GST.

VI. CONCLUSION

In the light of the above discussions, it is abundantly clear that, a robust, easy to follow classification system is necessary, for an efficient operation of Goods and Service Tax. If such a classification system, is broadly in alignment with International classification systems, as discussed in part-I and National classification systems designed for the purpose of economic statistics, as discussed in part-II, it would enable comparison and also support international trade negotiations.

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