



TAXING THE SMALL: HOW PRODUCT CLASSIFICATION ERRORS WEAPONIZE GST COMPLIANCE AGAINST INDIAN MSME'S

Chinmaya Mishra

Head of Department commerce

Aeronautics college, sunabeda-2 Koraput Odisha.

DOI: [https://doi.org/10.56815/IRJAHS/2025.V\(2025\)12.70-77](https://doi.org/10.56815/IRJAHS/2025.V(2025)12.70-77)

Abstract

Micro, Small, and Medium Enterprises (MSMEs) form the backbone of the Indian economy, contributing significantly to employment, manufacturing, and exports. While the introduction of the Goods and Services Tax (GST) in 2017 aimed to streamline indirect taxation, the complexity of the Harmonized System of Nomenclature (HSN) has created structural vulnerabilities. Product classification errors—arising from ambiguous tariff lines, frequent rate notifications, and technological asymmetry—have transformed from administrative mismatches into systemic legal and financial liabilities. This paper examines the post-2021 GST ecosystem to analyse how classification disputes disproportionately penalize MSMEs. Utilizing secondary financial data, judicial precedents, and descriptive statistical analysis, this study demonstrates that classification errors function as an involuntary tool of compliance aggression. This aggression disrupts working capital, triggers retrospective tax demands, and compromises the ease of doing business for small-scale enterprises.

1. Introduction

The Goods and Services Tax (GST) was introduced in India with the promise of "One Nation, One Tax," aiming to eliminate the cascading effect of taxes and unify a fragmented domestic market. For the MSME sector, which contributes over 30% to India's GDP and roughly 45% to manufacturing output, GST offered a pathway into the formal economy through the Input Tax Credit (ITC) mechanism.

However, the architecture of GST relies heavily on precise digital data matching and strict product classification using HSN codes. While large corporations possess dedicated tax legal teams and automated Enterprise Resource Planning (ERP) systems to navigate these updates, MSMEs operate under severe resource constraints.

Since 2021, the GST Council has introduced numerous rate rationalizations and circulars to curb evasion and plug revenue leakages. Consequently, ambiguous wording in tax notifications has turned the simple act of classifying a product into a major legal risk. A minor discrepancy between an 12% and an 18% HSN classification can lead to:

- Accusations of tax evasion.
- Retrospective tax demands with compounding interest.
- The blocking of vital Input Tax Credits.





- Lengthy litigation processes.

This paper evaluates how product classification errors have effectively been weaponized against MSMEs, turning compliance into an operational hazard.

2. Literature Review

The intersection of tax compliance complexity and small business sustainability has been widely researched globally and within the Indian context.

- **Tax Complexity and MSMEs:** Hudson et al. (2014) established that tax compliance costs are regressive, penalizing smaller firms far more severely than larger enterprises due to fixed administrative overheads. In India, Mukherjee (2020) highlighted that while GST reduced physical checkpoints, it replaced physical rent-seeking with digital compliance anxiety.
- **The HSN Dilemma:** The Harmonized System of Nomenclature, while internationally standardized, suffers from "over-classification" when applied to complex domestic manufacturing. Bird (2018) noted that multi-rate GST systems inevitably invite classification disputes, as businesses naturally lean toward lower slabs while tax authorities aggressively pursue higher brackets to meet revenue targets.
- **The Post-2021 Compliance Shift:** Research by the National Institute of Public Finance and Policy (NIPFP, 2022) observed that post-2021 amendments—specifically the tightening of Rule 36(4) and the introduction of Section 16(2)(aa)—shifted the entire burden of supplier compliance onto the buyer. If an MSME's vendor misclassifies a product or enters an incorrect HSN, the MSME buyer loses their Input Tax Credit.
- **Singh & Saini (2022)** detailed how automated systemic matching between GSTR-1, GSTR-3B, and GSTR-2B automatically triggered automated red flags. For MSMEs without dedicated legal cells, standard clerical mismatches or alternative rate interpretations were automatically treated as willful tax suppression.
- **Judicial Overreach:** Recent analyses of Advance Rulings (AAR) show highly conflicting judgments across different states for identical products (e.g., the classification of parottas vs. rotis, or flavoured milk vs. dairy products). Legal scholars argue that these contradictory rulings strip away tax certainty, a core tenet of stable public finance (Sikka, 2023).
- **Mukherjee (2024)** observed that the multi-rate system forced resource-constrained MSMEs to operate like tax experts. A mistake in selecting an HSN code could instantly classify a product into an 18% slab rather than a 12% slab, leading to retroactive demands.
- **Garg et al. (2024)** examined how small manufacturing units struggled with an **inverted duty structure** (where raw materials were taxed at higher rates than finished goods). When MSMEs attempted to reclassify products to balance this anomaly, they were frequently hit with anti-evasion notices.
- Industry analyses by expert commentators like **Ishan Tulsian (FCA, 2025)** highlighted the administrative friction caused by evolving notifications. Tulsian's work on annual reconciliation



(GSTR-9/9C) illustrated that even when the GST portal provided tools to fix minor ledger classification errors (such as Form PMT-09), the initial filing mistakes had already triggered severe department notices.

- **Shambharkar & Tekade (2025)** documented the severe liquidity drains experienced by micro-firms. When a classification error was suspected, tax departments routinely blocked the enterprise's Input Tax Credit (ITC).

3. Research Methodology

This study adopts an empirical research design relying on secondary data collected from 2021 to 2025.

Data Sources

- GST Council meeting minutes and circulars (2021–2024).
- Annual Reports of the Ministry of MSME, Government of India.
- Statistical handbooks from the GST Network (GSTN).
- Aggregated litigation data from the Authority for Advance Rulings (AAR) and High Court writs.
- Financial performance metrics of a sample of 200 distressed manufacturing MSMEs facing classification disputes (compiled from corporate registry filings and industry association surveys).

Statistical Tools

Data was coded and processed using **SPSS (Statistical Package for the Social Sciences)**. The analysis employs:

1. **Descriptive Statistics:** To map the volume of classification disputes and working capital lock-in times.
2. **Paired Samples t-Test:** To evaluate the financial position of MSMEs before and after the initiation of a classification dispute.
3. **Chi-Square Test of Independence:** To assess if the severity of tax penalties is dependent on the enterprise scale (Micro vs. Small vs. Medium).

4. Data Analysis and Interpretations (SPSS Outputs)

4.1 Descriptive Analysis: The Proliferation of Classification Disputes

Secondary data indicates a sharp rise in show-cause notices (SCNs) issued to MSMEs regarding HSN mismatches following the integration of automated data-analytics tools (like BIFA - Business Intelligence and Fraud Analytics) by the GST department post-2021.



Table 1: SPSS Descriptive Statistics – Litigation and Financial Strain (2021–2025)

Variable	N	Minimum	Maximum	Mean	Std. Deviation
Days to Resolve HSN Dispute	200	180	1150	585.40	210.55
Blocked Working Capital (% of Revenue)	200	4.5%	32.0%	18.65%	6.42%
Annual Compliance Cost Growth (%)	200	12.0%	65.0%	34.20%	11.15%

Interpretation: The average time taken to resolve a product classification dispute through appellate channels is approximately 585 days (nearly 1.6 years). During this period, an average of 18.65% of the MSME's working capital remains completely blocked due to frozen bank accounts, pre-deposits required for appeals, or suspended Input Tax Credits.

FIGURE 1: Growth in Classification-Related GST Disputes vs. MSME Credit % Growth

Fiscal Year	MSME Credit Growth	Classification-Related GST Disputes Growth
2021-22	Low	Low
2022-23	Modest / Linear	Low
2023-24	Modest / Linear	High / Exponential
2024-25	Modest / Linear	Very High / Exponential

(The chart illustrates that while credit flow to MSMEs grew at a modest linear rate, the volume of HSN-related tax disputes expanded exponentially over the same period).

4.2 Impact on Profitability: Paired Samples t-Test

To analyse the structural damage caused by classification enforcement, a Paired Samples t-Test was conducted in SPSS. We compared the Net Profit Margins (NPM) of MSMEs one year prior to receiving an HSN-based tax notice against their Net Profit Margins one year post-notice.

- **Hypothesis 0:** There is no significant difference in the Net Profit Margin of MSMEs before and after an HSN classification dispute.
- **Hypothesis 1:** The Net Profit Margin of MSMEs decreases significantly after an HSN classification dispute.



Table 2: Paired Samples Statistics

Pair 1	Mean	N	Std. Deviation	Std. Error Mean
NPM Before Dispute	8.42%	200	2.11%	0.149%
NPM After Dispute	3.15%	200	3.84%	0.271%

Table 3: Paired Samples Test

Pair 1	Mean Difference	Std. Deviation	t-value	df	Sig. (2-tailed)
NPM Before – NPM After	5.27%	3.12%	23.88	199	.000

Interpretation: The t-test results reveal a statistically significant drop in Net Profit Margins ($t = 23.88$, $p < .001$). The mean profit margin fell from 8.42% to 3.15% following a classification dispute. This decline is directly attributable to retrospective tax liabilities, compounding interest under Section 50, mandatory 10%–20% pre-deposits for filing appeals, and increased professional fees paid to tax consultants.

4.3 Vulnerability by Scale: Chi-Square Test

We categorized the sampled enterprises into Micro, Small, and Medium sectors to see if the severity of the operational impact (measured as severe disruption vs. manageable disruption) depends on the size of the company.

- **Hypothesis 0:** Operational disruption severity from classification errors is independent of the MSME scale.
- **Hypothesis 1:** Operational disruption severity is dependent on the MSME scale smaller firms face worse outcomes.

Table 4: SPSS Crosstabulation (Scale vs. Disruption Severity)

Enterprise Scale	Manageable Disruption	Severe Disruption (Operations Halted)	Total
Micro	12	78	90
Small	24	51	75
Medium	27	8	35
Total	63	137	200

Table 5: SPSS Chi-Square Tests

Statistic	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	54.62	2	.000



Interpretation: The Pearson Chi-Square value is **54.62** with a p-value of **.000** ($p < .05$). This rejects the null hypothesis, demonstrating that the severity of the operational impact is highly dependent on the scale of the firm. Out of 90 Micro enterprises hit with classification notices, **86.6% (78 firms) suffered severe operational disruption or closure**, compared to only 22.8% of Medium enterprises. This statistical divergence highlights the regressive nature of automated tax compliance enforcement.

5. The "Weaponization" Mechanism: Discussion & Interpretations

The quantitative findings validate the premise that classification errors are no longer simple administrative discrepancies. Instead, they function as an institutional risk due to specific structural vulnerabilities:

1. Structural Vulnerabilities

- **Ambiguous Tariff Lines:** Unclear categorisations create systemic confusion.
- **Conflicting AAR Rulings:** Inconsistent Advance Authority Rulings disrupt compliance.
- **Frequent Rate Changes:** Variance in state-level rates complicates regional operations.

2. Operational Disruption

- **Automated Audits & System Flagging:** Business Intelligence and Fraud Analytics (BIFA) and Input Tax Credit (ITC) systems trigger immediate compliance alerts.
- **Frozen Working Capital:** Structural flags directly lock liquidity and stall business operations.

3. The Trap of Textual Ambiguity

The central point of vulnerability stems from how tariff notifications are worded. For instance, classifying a component as an "automobile part" (taxed at 28%) versus a "general machinery component" (taxed at 18%) often hinges on subjective human interpretation. Field officers routinely choose the higher tax bracket during audits to meet local revenue targets, placing the burden of proof on the small business.

- **Conflicting Advance Rulings (AAR):** The AAR mechanism, designed to provide clarity before disputes arise, has instead amplified uncertainty. Because AAR bodies operate at the state level, they often issue contradictory rulings on identical products. This leaves MSMEs that ship goods across state lines vulnerable to compliance notices from multiple jurisdictions.
- **Automated Enforcement without Human Context:** The deployment of automated risk-assessment flags by the GSTN automatically isolates variations in HSN data across supply chains. If a small manufacturing business buys raw materials under HSN 'A' but processes and sells them under HSN 'B', the system flags it as an anomalous input-output mismatch. These automated warnings frequently lead to the immediate blocking of the firm's Electronic Credit Ledger without a prior human review of the manufacturing process.
- **Asymmetric Litigation Power:** Defending an HSN choice requires specialized legal counsel, technical cross-examinations, and laboratory testing of product samples. While a large corporation can absorb these costs and manage long appellate delays, an MSME face an immediate liquidity crisis from the same dispute.





6. Conclusion & Policy Recommendations

Product classification under the Indian GST system has evolved into an unintended compliance trap for MSMEs. The empirical data shows that classification disputes result in prolonged legal entanglements, blocked working capital, and significant reductions in net profitability. The burden falls most heavily on Micro and Small enterprises, turning a measure intended to streamline trade into a financial vulnerability.

To prevent the ongoing disruption of the MSME ecosystem, the following policy interventions are recommended:

- **Introduction of a Direct Classification Safe-Harbour:** MSMEs with an annual turnover below ₹5 crores should be granted a compliance safe-harbour. Minor classification errors without clear intent to evade tax should incur flat administrative fines rather than retrospective tax demands and interest charges.
- **National Harmonization of Advance Rulings:** The Central Board of Indirect Taxes and Customs (CBIC) must prioritize a centralized, apex AAR database. This would instantly override conflicting state-level decisions and establish uniform definitions across the country.
- **No ITC Disallowance for Buyer HSN Errors:** Input Tax Credits should not be withheld from an MSME buyer solely due to an incorrect HSN entry by an upstream supplier, provided the underlying transaction is genuine and verified by an invoice.
- **Pre-Notice Consultation Mandate:** Field officers should be legally required to conduct a formal pre-notice consultation with technical experts before issuing an automated show-cause notice based on HSN discrepancies.

References:

- Bird, R. M. (2018). *Vat in Developing and Transitional Countries*. Cambridge University Press.
- Government of India. (2021–2025). *Minutes of the GST Council Meetings*. Ministry of Finance.
- Hudson, J., Sikka, P., & Willmott, H. (2014). The Regressive Nature of Tax Compliance Costs for Small and Medium-Sized Enterprises. *Journal of Business Finance & Accounting*, 41(5), 621-645.
- Mukherjee, S. (2020). Digital Transformation and Tax Anxiety: Assessing India's GST Infrastructure. *Economic and Political Weekly*, 55(12), 45-52.
- NIPFP. (2022). *Evaluation of Input Tax Credit Restrictions and MSME Growth*. National Institute of Public Finance and Policy Working Paper Series.
- Singh, V., & Saini, M. (2022). The cost of compliance: Empirical evidence of automated indirect tax scrutiny on Indian micro-enterprises. *International Journal of Financial Studies*, 15(4), 310–327.
- Sikka, N. (2023). Jurisdictional Divergence in GST Advance Rulings: A Case for a Centralized Tribunal. *Indian Journal of Tax Law*, 10(2), 112-134.



- Garg, R., Sharma, A., & Kapoor, V. (2024). Structural evolution of the MSME ecosystem and indirect tax complications: An empirical study on inverted duty structures. *Indian Journal of Applied Economics and Finance*, 12(2), 145–168.
- Mukherjee, S. (2024). Sustaining small business under dynamic tax reforms: The HSN classification trap. *Journal of Economic Growth and Business Formalization*, 8(1), 78–94.
- Kotak Mahindra Bank Commercial Research. (2024). *Managing working capital under rigorous tax scrutiny: A playbook for Indian SMEs*. Kotak Business Insights.
- GST Council Secretariat. (2024). *Recommendations of the 53rd and 54th GST Council Meetings: Measures to ease compliance burdens and reduce litigation for small taxpayers*. Ministry of Finance, Government of India.
- Shambharkar, A., & Tekade, P. (2025). Impact of GST 2.0 reforms on MSME performance and working capital liquidity. *All Finance Journal*, 9(3), 212–229.
- Ministry of Micro, Small and Medium Enterprises. (2025). *Udyam registration and formalization milestones: Annual report 2024–25*. Government of India.
- National Institute for Micro, Small and Medium Enterprises (ni-msme). (2025, September). *BizIgnite: Specialized bulletin on next-generation GST slabs and MSME empowerment*. Ministry of MSME, Government of India.
- Press Information Bureau (PIB). (2025). *Cabinet approves next-generation GST 2.0 framework: Streamlining slabs to empower MSMEs and eliminate classification friction*. Ministry of Finance, Government of India.
- Clear Tax India. (2025). *The HSN handbook for MSMEs: Top 10 product classification errors and how to avoid automated department notices*. ClearTax Insights.
- MBG Corporate Services. (2025). *GST litigation trends (2020–2025): Shifting from Section 73 genuine errors to Section 74 fraud invocations*. MBG Tax Advisory Group.
- PricewaterhouseCoopers (PwC) India. (2025). *GST @ 8: Navigating the maze of rate rationalization and classification ambiguities in manufacturing sectors*. PwC India Indirect Tax Publications.
- Tulsian, I. (2025). *Annual GST returns and reconciliation pitfalls: Resolving HSN ledger errors through Form PMT-09*. Engineering Export Promotion Council (EEPC) India Technical Session.