Mandatory ISD Provisions
Do they end the need to cross charge?

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The debate between the Input Service Distributor (ISD) vs. Cross Charge mechanism has been ongoing since the introduction of the GST regime. Before this debate gained momentum, the Central Board of Indirect Taxes and Customs (CBIC) FAQ on IT and ITES released on 18 August 2017 inter alia clarified that ISD provision under the CGST Act, 2017, is not mandatory. Extracts of relevant FAQ reproduced hereunder:

Question 26: Is the requirement of transferring credit through the ISD mechanism mandatory?

Answer: The ISD provision under the CGST Act, 2017 is not mandatory. It only provides the manner of distribution of Input Tax Credit (ITC) wherever the business entity wishes to distribute the ITC as an Input Service Distributor.

Despite the FAQ, decisions by the Authority of Advance Ruling (AAR) and Appellate Authority for Advance Ruling (AAAR) went against the applicants. Key decisions by AAR/AAAR:

- In **Cummins India Ltd. {2022 (58) G.S.T.L. 549 (App. A.A.R. - GST - Mah.)}** - Head Office not being entitled to avail and utilize ITC of tax paid to third-party service vendors for common input services received by it on behalf of branch offices/units, appellant bound to take ISD registration if it intends to distribute such credit – Decision given by AAR {2019 (23) G.S.T.L. 559 (A.A.R. - GST)} was upheld.
- In **Tata Sia Airlines Ltd. {2021 (49) G.S.T.L. 195 (A.A.R. - GST - Haryana)}** - ITC pertaining to services only on the procurement made by HO towards maintenance of aircraft (including lease thereof) shall be distributed by way of ISD mechanism.

Taking note of the issue and the increasing litigation on the topic, the GST Council, in its 50th meeting on 11 July 2023, recommended a significant change by affirming that GST law does not mandate ISD registration. However, the Council hinted at prospective amendments to make the ISD mechanism mandatory for distributing ITC of common input services from third parties. In this relation, Circular No. 199/11/2023-GST was issued on 17 July 2023 by the CBIC, which inter alia clarified that the common charges and GST thereon can be transferred through a tax invoice by adopting the Cross Charging mechanism.

Furthermore, in the 52nd meeting on 7 October 2023, the GST Council fulfilled its commitment by recommending amendments to the CGST Act, 2017 and the Rules thereunder.

Reasons which led industries to prefer the Cross Charge mechanism over ISD

- As per Section 20 of the CGST Act, 2017, ISD can only distribute credit for the invoices raised on ISD registration. Therefore, the invoicing done on normal registration (by mistake or otherwise) can only be distributed through Cross Charge.
- ITC on account of input services received from a third party, which are liable to tax on a reverse charge basis, cannot be distributed through the ISD mechanism.
- The ITC available for distribution in a month must be mandatorily distributed in the same month, which could be a tedious task for most businesses.
- The only manner to distribute ITC under ISD was in the ratio of turnover of various units (unless a specific service is used for a single location). However, a more apt parameter to distribute ITC could be different; for instance, the number of employees, usage of space, impact of the service, units produced, etc.

- The ITC pertaining to inputs and capital goods used commonly across locations cannot be transferred through ISD.

As a result, the industry was either compelled to follow a Cross Charge mechanism or create a hybrid of transfers through ISD and Cross Charge. In some cases, some of the industry players have surrendered their ISD registrations or stopped receiving invoices thereon, thus completely shifting to the Cross Charge mechanism.

Changes proposed by the Finance Act 2024

The Finance Act 2024 proposes amendments to Sections 2(61) and 20 of the CGST Act, 2017 aiming to:

- Mandate ISD mechanism; and
- Expand the scope of distribution to include ITC on services taxable under the Reverse Charge Mechanism (RCM).

Given the above changes, the scope of using the Cross Charge mechanism as a substitute for ISD for distributing credit could be highly restricted.

Now the industry should watch for the following:

- Notification effecting changes proposed by the Finance Act 2024.
- Corresponding changes in Rule 39 of CGST Rules.
- Clarity on payment of tax under RCM - Whether RCM tax is required to be paid from ISD registration or normal registration? In case it is required to be paid by the normal registration, whether such normal registration is required to raise an invoice on ISD registration to enable the ISD to transfer credit to other branches?
- Expecting a revised Form GSTR-06 (ISD return) to incorporate the changes pertaining to GST payable under RCM from ISD registration.

It would be imperative to allow the ISD registration to make RCM payments and distribute the credit thereon to the recipient unit(s) to make the ISD option an effective mechanism. This would obviate the need to take additional registration solely to make RCM payments.

Simultaneously, the industry may take the following steps:

- Entities not having ISD registration or who had surrendered their ISD registration earlier may obtain the same in advance or as and when the changes are notified.
- The functional team should be guided on the changed procedure to be followed for distribution through ISD.
- Vendors should be instructed to raise invoices on ISD registration as and when entities decide to switch to the ISD option or when the changes are notified, whichever is earlier.
- Vet their list of services and vendors to identify such input services that need to be routed through ISD.
- Ensure that even the ineligible ITC of common input services is duly distributed to respective locations through ISD.
- Determine if there still persists any need to Cross Charge the expenditure despite having an ISD registration (for mandatory inter-unit billings or for Cross Charging GST on inputs and capital goods).

While the proposed provisions might leave the industry puzzled with a few questions, they do take a leap of faith toward mitigating the need for Cross Charging for common input services.

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