Navigating the credit distribution saga

The GST Council has its ears to the ground and is seeking to resolve to remove ambiguities. One such recommendation of the Council was to resolve a longstanding debate on whether transferring credit through the Input Service Distributor (ISD) is mandatory or whether a "cross-charge mechanism" can be adopted. The GST Council clarified that the GST law does not mandate taking ISD registration and also positively affirmed that the same can be transferred by raising a tax invoice, i.e., by cross-charging. Contrastingly, the Council also recommended that suitable amendments be made to the law to mandate the ISD mechanism prospectively.

The clarification has blessed the approach embraced by a substantial majority of businesses. This clarification provides greater clarity and confidence to the industry, enabling them to continue employing cross-charge mechanisms for credit transfers, eliminating the necessity for additional ISD registration. It would undoubtedly prevent long-drawn litigation to a tax-neutral issue. However, the flexibility may not be long-lasting, given the Council's intention to mandate ISD registration through suitable amendments in the law.

One fundamental question arises as to whether there is a need to have something like ISD in GST when GST law artificially mandates registration in each State of operation and then treats each such registration as a "distinct person." Any supply between distinct persons is liable to GST even without consideration. The purpose and intent of GST are better understood if one looks at the history of ISD in India and also dwells upon international references.

The concept of an ISD was introduced when the scope of service tax was enhanced to cover a wide range of services. The service tax so paid was allowed as a credit under the CENVAT Credit Rules 2004 for both manufacturers and service providers. The reason was the way Central Excise and Service tax compliances operated. While Central Excise registrations, compliances and excise duty payments were for each manufacturing location, service tax took a fundamental departure with a "centralized registration". This created an anomaly for a manufacturer with a multi-locational presence. Hence, a mechanism was needed to distribute the common credit across Central Excise and single-premise service tax registrations. It gave birth to the concept of ISD registration. Thus, the concept of ISD was devised to facilitate the transfer of input credit among multiple registrations, ensuring efficient credit utilization. It was a huge success and achieved the desired objective in the pre-GST era.

When GST was being introduced, the services sector, such as banking, telecom, airlines, etc., having a presence across various States represented, continued the centralized registration instead of state-wise registration. They pleased that the ISD mechanism could be used to transfer credit for services received in non-centralized registration States. However, the federal design of GST law made centralized registration impractical, and consequentially, GST law mandated obtaining registration in each state/union territory. However, the ISD mechanism was retained more as a facilitative measure similar to that done during pre-GST times for making ITC available in each registration of a distinct person. This probably explains why ISD was non-mandatory, as it was an additional facilitation for credit transfer.

Having seen the historical background, let's see how the ISD concept has fared in the GST regime. While under the GST regime, ISD has been instrumental in transferring the credits between distinct persons but had the following issues and complications:

Separate registration and compliance burden

The ISD mechanism requires separate registration and relevant compliances, burdening taxpayers from compliance and vendor management perspectives. There have been umpteen cases where vendors have punched in regular registration numbers instead of ISD ones.

Irrational credit distribution

The ISD mechanism allows credit distribution only in proportion to turnover, which may not be suitable for cases where credit allocation should be based on more rationale criteria; for e.g., ITC on software licenses must be distributed on the number of users which may not be aligned with turnover.

Not suitable for Reverse Charge Mechanism

ISD registration cannot make payments for reverse charge liability. This necessitated taxpayers to work around by transferring credit from their regular registration to ISD registration and then transferring the credit.

Limited scope for credit transfer

Conceptually, ISD was designed to facilitate the transfer of service credits, as it primarily revolved around the concept of service tax. However, post-implementation of GST, the concept was not extended to cover the transfer of goods-related credits. For instance, the purchase of assets at the corporate office, but revenue is generated by other registrations, a server being used for more than one registration. In all such cases, cross-charging was resorted to.

As a result of the above complications, since the introduction of GST, the industry has primarily disregarded the ISD mechanism. They either have chosen to remain away from it altogether since the beginning or opted out of the ISD registration over the period. The decision to largely refrain from the ambit of ISD does not come as a surprise, given the limited practicality and usage of the ISD provision in the GST framework. Instead, the cross-charge mechanism offers a more viable and preferable solution.

Even globally, no major economy has adopted the ISD mechanism. Countries such as Singapore, New Zealand, and Australia have embraced the concept of Group registrations wherein transactions between group members are disregarded for tax purposes. In jurisdictions such as Canada or the European Union, which have a similar federal structure as that of India, transactions are taxed on a cross-charge basis, but only when the recipient is not eligible to avail of the entire Input Tax Credit (ITC). Although none of these jurisdictions adopts an ISD-like mechanism for credit transfers, even the cross-charge mechanism, wherever used, is limited when the recipient cannot claim full ITC.

Having said that, while vide circular dated 17 July 2023, the Central Board of Indirect Taxes and Customs (CBIC) has acknowledged cross-charge as an alternative to the ISD mechanism, let us evaluate the cross-charge mechanism. The mechanism is based on the principles of supply under Section 7, read with Schedule I of the CGST Act, where a supply between distinct persons is liable to GST. Accordingly, ITC, under an invoice for common service issued at one registration for benefits used by other registrations, can be transferred by treating the service between distinct persons. However, a question may arise as to whether the nature of the transaction would be the original nature of supply or something else. For instance, if the head office obtains premise insurance for all its units across India, would the distribution of credit under cross-charge invoice be considered a supply of insurance services, or should it be classified as under a residuary category such as "support services"? Most taxpayers operating cross-charge mechanisms have opted to use "support service." The issue can be that if there is a differential tax rate, it will lead to an anomaly.

Furthermore, one may argue that there is no "support service" provided by the head office regarding insurance services. Consequently, credit of recipient registration could be denied for non-receipt of any service. ITC of the head office can also be denied on the ground that some part of the credit belongs to other registrations.

Another challenge is the transfer of ineligible ITC. Since the transferring unit typically would not be eligible to avail and utilize ITC of blocked credits for the limited purpose of distribution, whether the transferring unit should become eligible to avail. If not, how will the credit be distributed?

While cross-charging is a much more flexible methodology and is easy on compliance vis a vis ISD, it has its share of challenges, which can be addressed. Given that the GST Council has decided to mandate ISD methodology for credit transfer, we may have to wait for legislative amendments to determine the way forward. However, the cross-charge mechanism should be used for cases where ISD is not feasible.

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