

Navigating the Complexities of ISD Mechanism - An In-depth Analysis of Rule 54(1A)

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Background

Several amendments were made to the CGST Act and the CGST Rules via the Finance Act, 2024 and subsequent notifications pertaining to the input service distribution (ISD) mechanism which was made mandatory with effect from 1 April 2025 via the substituted section 20 and rule 39. Before 1 April 2025, distribution of common credit through ISD was not mandatory (as clarified in Circular No.199/11/2023-GST dated 17 July 2023). Thus, post 1 April 2025, it has become all the more critical to examine and analyse the ISD-related provisions.

Post 1 April 2025, one potential challenge for the industry is the invoice-wise identification and tagging of common input services, which is to be raised on the GSTN of the ISD, as well as their segregation from other invoices that may be specifically attributable. For a supplier, it would be difficult to track which invoice should be raised on which GSTN, namely, whether it should be the GSTN of the ISD or that of the specific branch. The following questions could arise: Can invoices for all credits, common as well as specific, be raised on the GSTN of the head office? All these invoices can then be examined and segregated to identify invoices relating to common input services that would be transferred via normal registration to the ISD. Can the industry adopt this as a default model? Does the law envisage this under rule 54(1A)?

This article answers all the above questions, along with a comprehensive analysis of rule 54(1A) and other ISD-related provisions, their implications, and the practical challenges businesses face while adhering to them. It also explores potential solutions and recommendations to ensure compliance and efficient credit distribution under the GST regime.

Analysis

Interpretation of rule 54(1A)

- Rule 54(1A) was introduced in January 2018 to facilitate the transfer of credit of common input services by a registration, other than an ISD registration (normal registration), having the same PAN and state code as the ISD, to the ISD.

- The wording of rule 54(1A) suggests that the credit of all common input services can be transferred by issuing an invoice prescribed therein. Interestingly, the Minutes of the 25th GST Council Meeting indicated that the primary intention of rule 54(1A) was to enable the transfer of common input service credit related to reverse charge only (Refer Annexure 1). However, a rule must be interpreted based on the wording of the law and not the intention as suggested in the 25th GST Council meeting.
- Thus, before the introduction of new provisions pursuant to the Finance Act, 2024 and notification dated July 2024, it could be said that the credit of all common input services (forward well as reverse charge) could be transferred from a normal registration to an ISD registration by issuance of an invoice prescribed under rule 54(1A) (rule 54(1A) invoice).

Subsequent revamp of ISD provisions in July 2024 w.e.f. 1 April 2025

New rule 39(1A) inserted

Via the notification issued subsequent to the Finance Act, 2024, rule 39(1A) was introduced, with effect from 1 April 2025. Until rule 39(1A) was introduced, there was no legal linkage between the provisions under rule 39, dealing with manner of ISD distribution, and rule 54(1A). However, while referring to rule 54(1A), rule 39 provides for the distribution of credit transferred to the ISD through a rule 54(1A) invoice for tax paid under reverse charge only. It does not mention the distribution of credit paid under forward charge.

Thus, even if one were to transfer all common credit (forward well as reverse charge), given the provisions of rule 54(1A), what would get distributed under rule 39(1A) is only the reverse charge related credit that is transferred. Rule 39(1A) does not allow the distribution of forward charge credit transferred to the ISD. Notably, the purpose of rule 54(1A) is to prescribe the particulars to be mentioned in the invoice for transferring credit to the ISD, whereas rule 39 prescribes the procedure for the distribution of credit by the ISD, gaining it powers from section 20. Rule 54(1A), which simply prescribes the particulars for the invoice, cannot be said to have the power to prescribe the procedure or manner of credit distribution, specifically when a specific rule, namely rule 39, which prescribes to the contrary

Section 20 substituted

Moreover, section 20, which deals with the manner of distribution of credit by the ISD, was also substituted via the Finance Act, 2024. Section 20(1) states that 'an office of the supplier', which receives input service invoices on behalf of a distinct person is required to be mandatorily registered as an ISD. Section 20(2) also provides that the ISD shall distribute 'tax charged' on invoices received by it, including credit of the tax paid under reverse charge on behalf of the distinct person. Therefore, it appears that section 20 allows an ISD to distribute credit only in respect of 'tax charged' on the invoice received by it. Section 20(2) deems that this would include tax paid under reverse charge.

Notably, there is no 'tax charged' in a rule 54(1A) invoice; it merely transfers credit. This is evident from the below:

- A rule 54(1A) invoice has lesser disclosure requirements as compared to a normal tax invoice issued under section 31 read with rule 46 (tax invoice).
- The 'rate of tax', 'amount of tax charged' etc. are required to be disclosed on a tax invoice but not for a rule 54(1A) invoice. A rule 54(1A) invoice only requires 'taxable value, rate and amount of the credit to be transferred'.

Based on the above, a rule 54(1A) invoice issued by a normal registration and received by an ISD cannot be said to be an invoice received by the ISD on which tax is charged in terms of section 20(2). In other words, where the credit transferred via a rule 54(1A) invoice is not a reverse charge related credit [expressly deemed to be included under section 20(2)], such credit cannot be distributed as per section 20(2) read with rule 39.

Can an invoice under section 31 be issued instead to transfer forward charge credit?

- Circular No. 199/11/2023GST dated 17 July 2023 (circular) states that, instead of distributing

common credit through an ISD, it can be distributed by a normal registration by issuing a tax invoice.

- It may be noted that this circular was issued before the provisions mandating ISD were introduced in the law. The ISD mechanism was not mandatory at the time of issuance of the circular, which is clear from the related clarification provided in the circular.
- Thus, it could be said that the circular can be applied only for the period before 1 April 2025 and not afterwards. Also, if one were to issue a tax invoice to transfer common credit even after 1 April 2025, the mandatory ISD mechanism would lose its meaning?
- Moreover, there needs to be an underlying supply to issue a tax invoice, which would be absent. The invoice would be issued simply for the purpose of transfer of credit without an underlying supply, which would be bad in law.
- Thus, recourse cannot be taken to the circular to issue a tax invoice to solve the abovementioned issue.

Stop-gap solution

Having discussed the legal interpretation of the law, it is also true that there is no other mechanism available to transfer the common credit of forward charge invoices. In view of the complexity of the deeming fiction of 'distinct person' coupled with the mandatory ISD mechanism, an invoice for a common input service being inadvertently raised on the GSTN of a normal registration instead of that of an ISD is bound to happen. Moreover, during the transitional period, there may be several common input service invoices relating to the period before 1 April 2025 which will be received post 1 April 2025 but issued on the GSTN normal registration. It would be a hassle for both the buyer and the supplier, to cancel / revise / amend the invoices. The industry may also wish to adopt this as a default model, wherein all invoices are raised on the GSTN of the normal registration, after which they are segregated into common input service invoices and specific invoices, and only the common input service invoices being transferred to the ISD. This would save compliance costs, require fewer resources and reduce duplication of efforts.

As a stop-gap solution and in the absence of any other mechanism being prescribed under the law, taxpayers may consider issuing a rule 54(1A) invoice to transfer forward charge credit as well. However, it is to be noted that this does not align with a strict reading of the law and may lead to litigation. This position would have to be defended basis the fact that it is procedural and does not lead to revenue loss to the government.

Disclosure issues in returns

Form GSTR 3B does not provide for a separate line item to disclose invoices issued under rule 54(1A) and the consequent transfer of credit. Currently, most taxpayers are disclosing the invoice issued under rule 54(1A) as a B2B invoice both in Form GSTR 1 and GSTR 3B. However, this leads to an artificial inflation of the turnover in the registration transferring the credit to the ISD, which in turn affects the ratio of distribution by the ISD which is based on the ratio of the turnover of the recipient registrations. This also skews the ratio for reversal of credit under rules 42 and 43 and other such reversals which are based on the turnover.

The alternative is to show it as a reversal of credit under 'other reversal' in the returns of the normal registration (to the extent of common input service). The ISD would disclose it in table 3 of Form GSTR 6 as credit available for distribution. However, it may be noted that this would lead to mismatch between Form GSTR 6A and GSTR 6, which may be questioned by the authorities.

In the absence of any reporting mechanism for a rule 54(1A) invoice in the law, the above are alternative potential work arounds for the short term, however clarity from the authorities on this aspect is required and is awaited.

Takeaways

Though the mandatory ISD mechanism has already come into effect, the law is still unclear and poses practical issues. Businesses need to navigate the ISD-related provisions carefully to ensure compliance. While a work around has been discussed for the short term, long-term clarity from the authorities is essential to ensure smooth credit distribution and avoid litigation. Since the ISD mechanism has already

become mandatory in April 2025, the government should take note of these practical issue and provide a workable solution to facilitate ease of doing business.

Disclaimer: The views expressed in this article are the personal views of the authors.

Annexure I

Relevant extract of the Agenda for the 25th GST Council Meeting (Page 81 of Agenda- Volume I):

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It was observed that there was no mechanism for insert sub-rule (1A) in rule 54 as below:

ISD to receive and pay tax

on services under reverse charge, except for taking person, having the same a normal registration. PAN and State code as an Even after taking Input Service Distributor, normal registration, there may issue an invoice or, was no mechanism for the as the case may be, a normally registered entity credit/debit note to to transfer credit, in transfer the credit of respect of such common common input services to services received under the Input Service reverse charge, to the Distributor, which shall contain the following details:

generating a special

invoice needs to be. name, address and provided for normally Goods and Services Tax registered persons to identification Number of allow passing of such the registered person credit to ISD for further having the same PAN and distribution. same State code as the Input Service Distributor;

ii. a consecutive serial number not exceeding sixteen characters, in one or multiple series, containing alphabets or numerals or special characters hyphen or dash and slash symbolised as, "-", "/" respectively, and any combination thereof, unique for a financial year;

iii. date of its issue;

iv. Goods and Services Tax Identification Number of supplier of common service and original invoice number whose credit is sought to be transferred to the Input Service Distributor;

v. name, address and Goods and Services Tax Identification Number of the Input Service Distributor;

vi. taxable value, rate and amount of the credit to be transferred; and

vii. signature or digital signature of the registered person or his authorised representative.

(b) The taxable value in the invoice issued under clause (a) shall be the same as the value of the common services."

Relevant extract of the Agenda for the 50th GST Council Meeting (Page 50 of Agenda- Volume II):

Agenda Item 3(xix): Issues pertaining to ISD mechanism and taxability of services provided by one distinct person to another distinct person.

7.1 For common input services procured from third party:

7.1.2 For prospective periods

7.1.2.1 Law Committee took a view that ISD procedure, as laid down in Section 20 of CGST Act read with rule 39 of the CGST Rules, may be made mandatory prospectively for distribution of ITC in respect of input services procured by Head Office (HO) from a third party but attributable to both HO and Branch Office (BO) or exclusively to one or more BOs. Further, ITC on account of input services received from a third party, where such input services are liable to tax on reverse charge basis, should also be required to be distributed through ISD route. This will require amendment in law which the Law Committee may formulate in due course.

7.1.2.2 Further, Law Committee also took a view that the manner of distribution of ISD credit as provided in section 20 does not require amendment at present. However, alternate objective criteria may be explored in future, if deemed appropriate, after consultation with trade.