Input Service Distributor Mechanism Under GST : Necessity, Compliance Challenges, and Accounting Treatment

Introduction

The Input Service Distributor (ISD) mechanism is not a novel concept in India's indirect tax framework. It existed under the erstwhile Service Tax regime, enabling head offices or central offices to distribute input service credit to various units.

With the advent of Goods and Services Tax (GST) on 1st July 2017, a single nationwide indirect tax was introduced in the form of CGST, SGST, IGST, and UTGST. GST follows the principle of **destination-based taxation**, i.e., revenue is intended to accrue to the State in which the goods or services are consumed. While this was a structural improvement over the earlier fragmented system, a significant challenge persisted: how to determine the **appropriate State to which tax revenue should accrue**

The government earns most of its revenue from two categories:

1. **B2C sales transactions**, where the end consumer does not claim ITC.
2. **Blocked ITC**, where credit is specifically disallowed even though the supplies are made for business purposes (e.g., personal expenses, motor vehicles, immovable property).

As far as blocked credit is concerned, for goods, identifying the destination is relatively straightforward. However, for services, the matter is more complicated. A service like an advertising campaign, a national IT software license, or a group audit may be used across multiple States, but if the invoice is raised in the name of only one GSTIN, that State alone enjoys the ITC benefit. This distorts the intended revenue sharing principle and creates inequity between States especially in case of ineligible ITC such as Rent-a-cab.

Further, Section 16(1) of the CGST Act permits ITC on goods or services "used or intended to be used in the course or furtherance of his business." The term *"his"* refers narrowly to the business of the registered person under a particular GSTIN or on PAN level is subject to litigation. Thus, when an invoice is billed to one registration but the service benefits multiple registrations, tax authorities may argue that the full ITC is not available to the single GSTIN.

To address this, the ISD mechanism was retained under GST. It allows a central office to redistribute credits to multiple units in proportion to turnover, ensuring consuming States receive the benefit and protecting businesses from ITC denial. However, ambiguities persisted. Debate arose on whether ISD was mandatory or if cross-charge

could substitute it. Further questions emerged about overlaps between ISD and cross-charge, and whether RCM services could also be distributed through ISD.
ISD is applicable in case where third-party services are not consumed by single GSTIN but commonly used amongst distinct persons whereas cross charge is applicable wherein one distinct person provides services to another.

Also, in case of ISD, No supply of service is involved; it is merely an allocation mechanism Whereas, Cross charge involves supply of services amongst distinct entities.

Also, There is no prescribed valuation method for services between branches in case of cross charge and can be litigated. ISD, on the other hand, allows distribution based on turnover ratio, offering clarity and reducing disputes.

Due to confusion over procedural issues various companies opted to allocate RCM credits via cross-charge, which is not always appropriate. To settle this, Rule 39(1A) was introduced by Notification No. 28/2018-CT (13th June 2018), expressly providing that RCM credits can also be routed through ISD for proportionate distribution.

As per Rule 39(*1A) For the distribution of credit in respect of input services, attributable to one or more distinct persons, subject to levy of tax under sub-section (3) or (4) of section 9, a registered person, having the same PAN and State code as an Input Service Distributor, may issue an invoice or, as the case may be, a credit or debit note as per the provisions of sub-rule (1A) of rule 54 to transfer the credit of such common input services to the Input Service Distributor.*

If a business operates in multiple States with different GSTINs for each branch, Rule 39(1A) indirectly requires the business to take separate ISD registrations in each State where it is receiving services liable for reverse charge and consumed by multiple GST registrations.

For example, if a company has branches in Maharashtra and Gujarat, it must register as an ISD in both Maharashtra and Gujarat in order to receive the RCM-paid ITC from the respective branches in each State.

Thus, ISD evolved from being a mechanism limited to third-party input services to also covering RCM credits. Today, ISD is the proper route for allocation of common service credits and RCM liabilities, while cross-charge is reserved for actual supplies between distinct persons. This dual structure reduces disputes, ensures equitable revenue distribution, and strengthens the destination-based character of GST.

Manner of Distribution of Input Tax Credit

The Input Service Distributor (ISD) mechanism is vital for the distribution of Reverse Charge Mechanism (RCM)-paid Input Tax Credit (ITC) across various branches or units within the same legal entity. As per Rule 39(1A), the ISD receives the RCM ITC and distributes it to each unit based on their actual consumption of services, ensuring proper compliance with GST regulations.

Key Provisions Governing the Distribution of RCM ITC

Section 20(2) specifically authorizes the **ISD** to **distribute CGST or IGST credits**, including those related to services taxed under **RCM provisions** (as per **Section 9(3)** and **Section 9(4)** of the **CGST Act** or **Section 5(3)** and **Section 5(4)** of the **IGST Act**), to units sharing the same **PAN.**

Section 20(3) and Rule 39 further clarifies that:

- Credit of CGST shall be distributed either as CGST or IGST,
- Credit of IGST shall be distributed either as IGST or CGST,

The same is tabulated as under -

Input Tax Received by ISD	Recipient Location	Distribute As
IGST	Same State as ISD	IGST
IGST	Different State from ISD	IGST
CGST + SGST / UTGST	Same State as ISD	CGST + SGST / UTGST
CGST + SGST / UTGST	Different State from ISD	IGST

Scenario:

XYZ Limited is a company engaged in the business of auto components manufacturing and has obtained multiple GST registrations in Maharashtra, Gujarat and Delhi and ISD registration at its Head Office (HO) located in Mumbai.
XYZ Limited has engaged a reputed law firm having registrations in Maharashtra and Karnataka respectively to provide professional legal and advisory services in connection with its business operations.

Both the law firms have raised tax invoices dated 31st May 2025 for legal advisory services in the name of XYZ Limited's Head Office in Maharashtra, as per the centralized procurement arrangement as follows:

Sr No.	Name	Taxable value	Reverse Charge Liability u/s 9(3)		
			CGST	SGST	IGST
1	ABC	₹1,00,000	₹9000	₹9000	-
2	PQR	₹2,00,000	-	-	₹36000

Solution :

Step 1: Pay RCM Under Normal GST Registration

- Maharashtra's regular GSTIN will discharge RCM on the said transaction through GSTR-3B for the month of May 2025
- Payment made via cash ledger, reported in GSTR-3B Table 3.1(d)

Sr No.	Particulars	Debit	Credit
1	RCM Input CGST - MH	9,000	
	RCM Input SGST - MH	9,000	
	RCM Input IGST - MH	36,000	
	RCM Payable CGST - MH		9,000
	RCM Payable SGST - MH		9,000
	RCM Payable IGST - MH		36,000
	(Being RCM input & Liability booked)		
2	RCM Payable CGST - MH	9,000	
	RCM Payable SGST - MH	9,000	
	RCM Payable IGST - MH	36,000	
	Electronic Cash Ledger		54,000
	(Being RCM Liability paid)		
3	Electronic Cash Ledger	54,000	
	Bank		54,000
	(Being RCM Liability paid)		

Step 2: Avail RCM ITC in Normal GSTIN

- MH GSTIN can avail the corresponding ITC under **Section 16 in the month of May 2025.**
- **Claim in GSTR-3B:** The ITC is claimed in **Table 4(A)(3)** of **GSTR-3B** as "Inward supplies liable to reverse charge".

Sr No.	Particulars	Debit	Credit
4	Electronic Credit Ledger	54,000	
	RCM Input CGST - MH		9,000
	RCM Input SGST - MH		9,000
	RCM Input IGST - MH		36,000
	(Being RCM Credit received)		

Step 3: Transfer RCM ITC to ISD GSTIN (Head Office to ISD)

As per **Rule 54(1A) of the CGST Rules**, where a registered person issues an invoice to an Input Service Distributor (ISD) for the purpose of distributing Input Tax Credit (ITC) pertaining to common input services, the invoice shall **mandatorily contain** the following **additional particulars** as compared to invoice under Rule 46:

- **Goods and Services Tax Identification Number (GSTIN)** of the original supplier of the common service; and
- **Original invoice number** against which the credit is being distributed to the ISD.

The following details, which are otherwise required under Rule 46, **need not be included** in such invoices raised for ITC distribution to the ISD:

- Harmonised System of Nomenclature (HSN) code for goods or services
- Description of goods or services
- Quantity (in case of goods) and the unit or Unique Quantity Code (UQC)
- Place of supply along with the name of the State, in the case of inter-State supply

While Rule 54(1A) does not expressly require the inclusion of a **QR code with embedded Invoice Reference Number (IRN)**, the requirement under **Rule 48(4)** remains applicable. Accordingly, if the registered person falls under the ambit of e-invoicing, then e-invoices issued to the ISD shall also be subject to **mandatory IRN generation and QR code embedding** in compliance with Rule 48(4).

Sr No.	Particulars	Debit	Credit
5	ISD Input Receivable	54,000	
	Output CGST - MH		9,000
	Output SGST - MH		9,000
	Output IGST - MH		36,000

	(Being Input tax credit transferred to ISD)		
6	Output CGST – MH	9,000	
	Output SGST – MH	9,000	
	Output IGST – MH	36,000	
	Electronic Credit Ledger		54,000
	(Being Input tax credit transferred to ISD)		

Step 4: Distribute ITC to Units Through ISD Mechanism

ISD issues a **statutory transfer invoice** to the normal GSTIN to transfer the RCM-related ITC as per rule 54(1) which states

Turnover: Maharashtra = ₹40L, Gujarat = ₹30L, Delhi = ₹30L
Total Turnover = ₹1 crore

Scenario 1: Only one branch avails the Benefit

Situation : The service is used exclusively by **one GST-registered branch** (e.g., Gujarat branch).
Method of Distribution:

- The **entire ITC** is distributed **only to the beneficiary branch**.
- No need to apportion ITC across other branches.
- ISD issues an invoice **directly to that branch**.

Sr No.	Particulars	Debit	Credit
7	IGST Input - GUJRAT	54,000	
	ISD Input Receivable		54,000
	(Being Proportionate input tax credit received)		
8	Electronic Credit Ledger	54,000	
	IGST Input - GUJRAT		54,000
	(Being input tax credit claimed)		

Scenario 2: Only Maharashtra and Delhi Avail the Benefit (40:30)

- ITC To be distributed
  - CGST = ₹9000
  - SGST = ₹9000
  - IGST = ₹36000

Unit	Turnover	CGST	SGST	IGST	Total ITC Distributed
Maharashtra (HO)	₹40,00,000	₹5,143	₹5,143	₹20,570	₹30,856
Delhi Branch	₹30,00,000			₹23,144	₹23,144
Total	**₹70,00,000**	**₹5,143**	**₹5,143**	**₹43,714**	**₹54,000**

Sr No.	Particulars	Debit	Credit
7	CGST Input - MH	5,143	
	SGST Input - MH	5,143	
	IGST Input - MH	20,570	
	IGST Input - GUJRAT	23,144	
	ISD Input Receivable		54,000
	(Being Proportionate input tax credit received)		
8	Electronic Credit Ledger	54,000	
	CGST Input - MH		5,143
	SGST Input - MH		5,143
	IGST Input - MH		20,570
	IGST Input - GUJRAT		23,144
	(Being input tax credit claimed)		

Scenario 3: All Units Avail the Services (40:30:30)

- ITC To be distributed
    - CGST = ₹9000
    - SGST = ₹9000
    - IGST = ₹36000

Unit	Turnover	CGST	SGST	IGST	Total ITC Distributed
Maharashtra (HO)	₹40,00,000	₹3,600	₹3,600	₹14,400	₹21,600
Gujrat Branch	₹30,00,000			₹16,200	₹16,200
Delhi Branch	₹30,00,000			₹16,200	₹16,200
Total	**₹1,00,00,000**	**₹3,600**	**₹3,600**	**₹46,800**	**₹54,000**

Sr No.	Particulars	Debit	Credit
7	CGST Input - MH	3,600	
	SGST Input - MH	3,600	
	IGST Input - MH	14,400	
	IGST Input - GUJRAT	16,200	
	IGST Input - DELHI	16,200	
	ISD Input Receivable		54,000
	(Being Proportionate input tax credit received)		
8	Electronic Credit Ledger	54,000	
	CGST Input - MH		3,600
	SGST Input - MH		3,600
	IGST Input - MH		14,400
	IGST Input - GUJRAT		16,200
	IGST Input - DELHI		16,200
	(Being input tax credit claimed)		

Manner of Reduction of Input Tax Credit on account of Credit Notes

As discussed earlier, the ISD framework ensures that common input services availed at one location can be fairly distributed across multiple registrations of the same entity. However, practical challenges arise when the original supplier subsequently issues a credit note.

A credit note may be issued due to:

- Post-supply discounts,
- Cancellation of services, or
- Correction of excess billing.

In such cases, the ITC originally distributed by the ISD now stands reduced. If no adjustment mechanism existed, one branch could continue to retain excess ITC while the overall entity would have claimed more credit than eligible. To avoid such distortion, the law mandates that the reduction in ITC must also be apportioned among the recipients in the same ratio in which the original credit was distributed. This ensures neutrality and maintains the integrity of the ISD system.

Scenario

In our earlier example of XYZ Limited, ITC on legal services was distributed by the ISD in May 2025 based on:

Turnover: Maharashtra = ₹40L, Gujarat = ₹30L, Delhi = ₹30L

Total Turnover = ₹1 crore

Ratio: (40:30:30)

However, in June 2025, **Law Firm PQR** issued a **credit note of ₹50,000 + IGST ₹9,000**.

The turnover by then had changed (50:30:20).

Solution:

As per law, the reduction in Input Tax Credit w.r.t credit note must be apportioned in the original ratio (40:30:30), not the revised ratio.

Even if turnover changes later, credit note adjustments always follow the ratio of original ITC distribution.

Unit	Original Share	Credit Note Adjustment
Maharashtra (HO)	40%	3,600
Gujarat Branch	30%	2,700
Delhi Branch	30%	2,700
Total	**100%**	**9,000**

Assuming all three units availed service :

<table>
<tr><th>Sr No.</th><th>Particulars</th><th>Debit</th><th>Credit</th></tr>
<tr><td rowspan="5">1</td><td>ISD Input Receivable</td><td>9,000</td><td></td></tr>
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<tr><td>IGST Input - DELHI</td><td></td><td>2,700</td></tr>
<tr><td>(Being reversal of IGST input tax credit on account of credit note)</td><td></td><td></td></tr>
<tr><td></td><td></td><td></td><td></td></tr>
<tr><td rowspan="5">2</td><td>IGST Input - MH</td><td>3,600</td><td></td></tr>
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<tr><td>Electronic Credit Ledger</td><td></td><td>9,000</td></tr>
<tr><td>(Being input tax credit reversed)</td><td></td><td></td></tr>
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Manner of distribution of Input Tax Credit on account of Debit Notes

Legal Provision:

- Under **Rule 39(1)(m) of the CGST Rules**, if a supplier issues a **debit note** to an ISD, it increases the tax value on the original supply.
- Consequently, the ISD becomes entitled to an **additional amount of input tax credit (ITC)**, which must be distributed.
- The debit note is treated **independently** almost like a fresh invoice and not merely an adjustment of the old one.

Implications in Practice:

- A debit note is **not linked back to the original turnover ratio** used for distributing the initial invoice. Instead, it is treated like a **new inflow of ITC** and allocated based on the **current turnover figures of the respective units**.
- This may result in the same service being apportioned across branches using **different ratios at different times** once when the original invoice was distributed, and again when the debit note is distributed.
- While legally permissible, this can sometimes cause reconciliation mismatches if businesses do not maintain clear documentation.

Distribution of Ineligible ITC by Input Service Distributor (ISD)

Under **Rule 39(1)(g)** of the **CGST Rules**, the **Input Service Distributor (ISD)** is required to distribute both eligible and ineligible ITC **separately to the recipients in proportion of their turnover.**
However, it is essential to understand that **ineligible ITC**, which is defined under **Section 17(5)** of the **CGST Act**, such as credit on **personal consumption**, **motor vehicles**, or **construction of immovable property cannot be utilized** by the recipient units.

Despite these restrictions, the ISD is still required to **distribute ineligible ITC** to the recipient units for compliance purposes. The recipient units are required to **reverse** this ineligible credit in their respective **GSTR-3B** filings.

Conclusion:

The ISD mechanism under GST ensures fair distribution of ITC for common and RCM services across multiple registrations of the same entity. It supports the destination-based tax structure and prevents credit accumulation at one location. While it offers clarity and reduces disputes, businesses must manage compliance carefully, especially around registration, documentation, and handling of ineligible ITC. When properly implemented, ISD promotes efficient credit utilization and GST compliance.

Author's Note:

This article is intended for informational purposes only and does not constitute legal advice. Businesses are advised to consult professional advisors for tailored litigation and compliance strategies.
