

EY Tax Alert

Madras HC holds fulfilment of conditions under section 16(2) necessary before ITC is distributed by ISD

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Executive summary

This Tax Alert summarizes a recent ruling of the Madras High Court (HC)¹, on the validity of Rule 39(1)(a) of the Central Goods and Services Tax Rules, 2017 (CGST Rules) requiring an Input Service Distributor (ISD) to distribute input tax credit (ITC) in the same month in which it is available for distribution.

The key observations of the HC are:

- On a bare reading of the provisions contained in Section 16(2) of the Central Goods and Services Tax Act, 2017 (CGST Act), it is clear that no registered person shall be entitled to input tax credit (ITC) unless the conditions prescribed therein are fulfilled. Mere receipt of invoice does not entitle a person to claim ITC.
- The expression “the input tax credit available for distribution in a month” contained in Rule 39(1)(a) on rational, fair, and logical interpretation would only mean ITC available for distribution in a month upon fulfillment of all the conditions incorporated in Section 16(2).
- The requirement that distribution of credit shall be upon receipt of invoices does not mean that distribution has to take place even before the registered person is entitled to ITC.
- If the law is interpreted as above, Rule 39(1)(a) is not required to be declared ultra vires the enabling Act.

Basis above, HC allowed the writ petition and held that ITC need not necessarily be distributed in the month in which invoice is received. It remanded the matter back to Revenue to be adjudicated on the basis of harmonious interpretation made by the Court.

¹ TS-137-HC(MAD)-2026-GST

Background

- Petitioner is engaged in the business of telecommunication services and have separate goods and services tax (GST) registrations in each State from where it supplies services. Each such registration is treated as a distinct person.
- The GST law provides for the concept of Input Service Distributer (ISD) for distribution of input tax credit (ITC) on common expenses to branches/units having the same Permanent Account Number (PAN).
- Section 20 of the Central Goods and Services Tax Act, 2017 (CGST Act) provides for manner of distribution of credit by ISD.
- In terms of Rule 39(1)(a) of the Central Goods and Services Tax Rules, 2017 (CGST Rules), ITC available for distribution in a month shall be distributed in the same month.
- Show cause notice was issued to the petitioner *inter alia* alleging contravention of above provisions on the ground that ISD credit was not distributed in the same month in which invoices were received.
- Aggrieved, petitioner filed a writ petition before the Madras High Court (HC) to challenge the validity of Rule 39(1)(a) in respect of two periods, viz., prior to 1 April 2025 and thereafter.

Petitioner's Contentions

- Prior to 1 April 2025, Section 20 did not empower the Central Government to prescribe the time limit within which the ISD was required to distribute credit.

The power to do so was introduced with effect from 1 April 2025 by insertion of the phrase "*within such time and subject to such restrictions and conditions as may be prescribed*" in sub-section (2) of aforesaid Section.

- Rule 39(1)(a) of CGST Rules provides for procedure for distribution of credit of ITC by ISD. It *inter alia* provides that "*the input tax credit available for distribution in a month shall be distributed in the same month*".

The aforesaid time-limit existed in Rule 39(1)(a) since 1 July 2017.

Accordingly, prior to 1 April 2025, the said Rule was beyond the scope and powers vested by the parent legislation.

- The amendment to Section 20 can apply only prospectively, as it is a settled proposition of law that an amendment is prospective, unless expressly stated to be retrospective. The amendment can also not be termed as "clarificatory" to apply retrospectively.
- Even so, it is impossible to distribute the ITC without ensuring compliance with the conditions stipulated under Section 16. Moreover, a taxpayer needs to ascertain as to which unit the input service in question was attributable to, before applying the distribution formula prescribed under aforesaid provisions.
- When Section 16(4) of the CGST Act stipulates a time

limit for claiming credit, of around November of the subsequent financial year in which the invoice was issued, any stipulation that the distribution must happen forthwith is unreasonable and arbitrary.

- Rule 39(1)(a) has to be read down and the phrase "*available for distribution*" employed therein is to be interpreted to mean when the conditions under Section 16 have been fulfilled.
- Entitlement to ITC arises only when the conditions of Section 16 are satisfied.
- If not followed, there could be adverse consequences, including liability for interest and penalty under Section 21 read with Sections 73 and 74.
 - There is no revenue loss if the distribution is done in a month after the month of issuance of invoice and, in any event, it is to the taxpayer's detriment to delay distribution, in as much as the undistributed credit cannot be set off against output liability till it is distributed.
 - It is the ISD which must segregate eligible and ineligible ITC and distribute them. In a case where the GST invoice is issued on the last day of a month, it is impossible to distribute ITC through ISD invoice on the same day or the next day.
 - Reliance can be placed on the Supreme Court (SC) judgment², wherein Rule 6 of the Central Sales Tax (Kerala) Rules, 1957 was struck down as being ultra vires Section 8 of the Central Sales Tax Act, as the parent provision did not empower prescription of a time limit.

Revenue's Contentions

- Rule 39(1)(a) has been validly framed in exercise of the rulemaking power conferred under Section 164, read with Section 20, which empowers the government to prescribe the manner of distribution of ITC by ISD. The rule operates within the statutory framework and is a necessary supplement to the substantive provisions.
- The same-month distribution requirement is neither impossible nor arbitrary. It serves the legitimate purpose of maintaining the integrity of the GST system and preventing revenue leakage.
- The amendment to Section 20(2) with effect from 1 April 2025, inserting the phrase "*within such time and subject to such restrictions and conditions as may be prescribed*" is only a clarificatory amendment and clarifies what was already in Section 20 and validates the existing Rule 39(1)(a).
- ISD distribution is not the same as "*taking*" or "*availing*" ITC under Section 16. It is merely an internal accounting adjustment, a book entry transferring credit from the ISD registration to recipient registrations under the same PAN.
- The present writ petition is premature and not maintainable as the SCN is pending adjudication.
- Section 16(4) has no application to ISD distribution time limit. The said provision deals with the outer time limit for actual recipients to claim ITC in their

² [AIR 1967 SC 1823]

books and returns.

It has no connection whatsoever with the ISD's obligation to distribute credit in the same month as the invoice under Rule 39(1)(a).

- Reliance can be placed upon a ruling of the SC³, wherein it was held that procedural conditions for availing tax benefits are within legislative competence and do not violate fundamental rights if they are reasonable and serve legitimate policy objectives.

It can be said that the same-month distribution requirement under Rule 39(1)(a) is a reasonable procedural condition serving the legitimate objectives of revenue protection and prevention of fraud.

- Reliance is also placed on a ruling of the SC⁴, wherein it was categorically held that ITC is a statutory benefit subject to conditions prescribed by law. The conditions cannot be termed as unreasonable merely because they require diligent compliance by taxpayers.

This principle fully supports the validity of Rule 39(1)(a), which prescribes a reasonable timeline for ISD credit distribution.

HC Ruling

- On a bare reading of the provisions contained in Section 16(2), it is clear that no registered person shall be entitled to the credit of any input tax in respect of any supply of goods or services to him, unless the conditions prescribed in clauses (a), (aa), (b), (ba), (c) and (d) are fulfilled.
- A conjoint reading of the provisions contained in Section 16, along with Rules 37, 37A and 38, would reveal that mere receipt of invoice does not entitle the registered dealer to claim ITC without fulfillment of other conditions enumerated therein.
- Section 20, as it stood prior to 1 April 2025, did not contain the expression "*in such manner as may be prescribed*". It was only by way of amendment with effect from 1 April 2025 that new Section 20 was substituted by Finance Act, 2024.
- Rule 39 has been framed in exercise of power of delegated legislation by the Central Government and, therefore, has necessarily to be consistent with and within the limits of the rule making power as delegated under the enabling Act.
- The expression "*The Input Service Distributor shall distribute the credit of central tax or integrated tax charged on invoices received by him*" has to be interpreted keeping in view the other provisions contained not only in Section 20, but also in Section 16.
- It is one of the cardinal principles of interpretation that a provision contained in the statute has to be read as a whole and keeping in view the scheme and other provisions contained therein and not *de hors* the same.
- The use of the expression that distribution of credit

shall be upon receipt of invoices does not mean that distribution has to take place even before the registered person is entitled to ITC under Section 16. Such an interpretation will create absurdity and anomaly.

- There is no discernible principle as to why, for the purpose of distribution of credit, Section 16 has to be kept at bay.

If that was the intention of the legislature, it could well be indicated by using the expression signifying the legislative intention as "*irrespective of whether or not the registered person is entitled to credit of any input tax in respect of supply of any goods or services or both to him*". However, the legislature has not chosen to incorporate such expression.

- The language of Section 20 does not talk of distribution of "invoice", but of "credit". Merely because the expression used is distribution of credit upon receipt of "invoice", it cannot be taken to mean that the legislative intention is to mandate distribution of credit indicated in the invoice even before the registered person is entitled to claim ITC.
- The expression "*the input tax credit available for distribution in a month*", on rational, fair, and logical interpretation would only mean ITC available for distribution in a month upon fulfillment of the conditions incorporated in Section 16(2).

In other words, the distribution mechanism is triggered only after completion of various stages and conditions incorporated in Section 16(2). Therefore, the requirement of distribution has to be accordingly construed to mean that it shall be in the month in which the registered person becomes entitled to ITC in terms of Section 16(2).

- If the law is interpreted as above, Rule 39(1)(a) is not required to be declared *ultra vires* the enabling Act.
- Accordingly, HC held that ITC need not necessarily be distributed in the month in which invoice is received, rather ISD distribution mechanism is triggered only after satisfaction of conditions for availment of ITC.
- Further, in view of the aforesaid conclusion, the issue raised for consideration post amendment is also answered accordingly.

³ (2016) 15 SCC 125

⁴ (2022) 2 SCC 603

Comments

- a. This ruling provides clarity on the long-standing issue surrounding ISD credit distribution timelines. By adopting a purposive and harmonious interpretation, the HC has avoided striking down delegated legislation while simultaneously curbing arbitrary administrative interpretation.
- b. In an earlier ruling, for the period prior to the amendment in Section 20, Telangana HC had struck down Rule 39(1)(a) to the extent it mandated ISDs to distribute ITC within the same month as the same was not backed by the CGST Act [(2026) 38 Centax 172].

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