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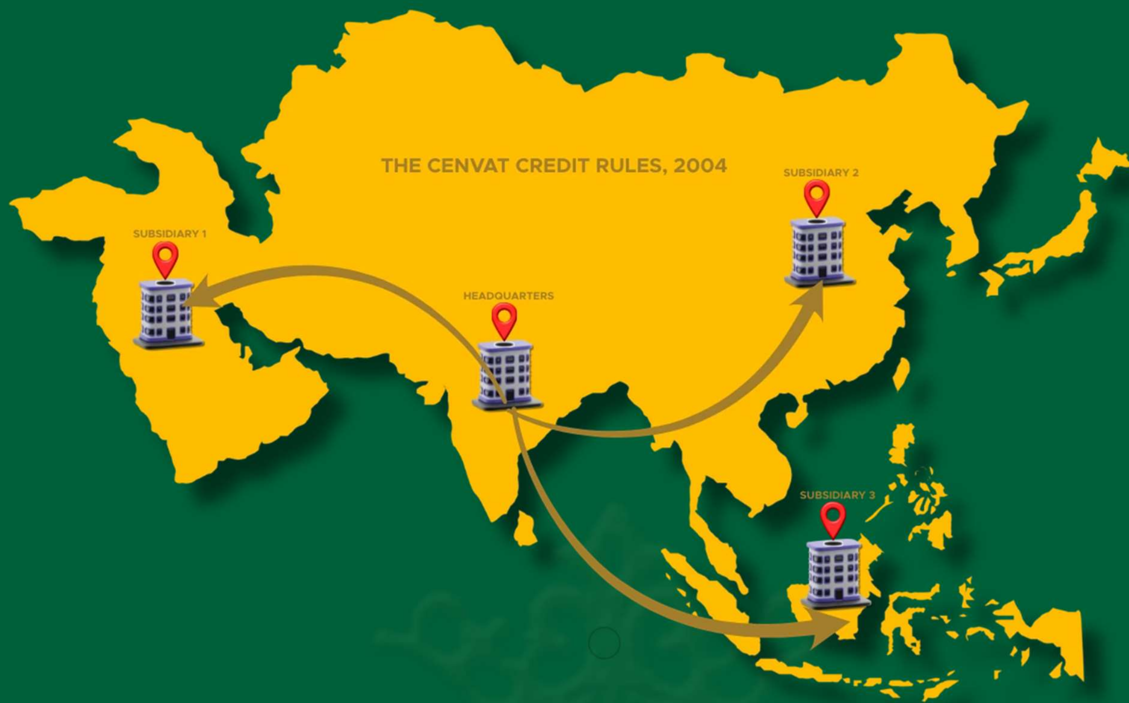
# The Nexus Conundrum: Input Tax Credit and International Service Delivery




The intricate world of indirect taxation often presents complex scenarios where the interplay of regulations and business models leads to protracted legal battles. A recent judgment by an appellate tribunal in India, concerning a company providing information technology software services primarily to overseas clients, throws light on the nuanced interpretation of "input service" under the Cenvat Credit Rules, 2004, particularly in the context of cross-border transactions involving subsidiaries. This article delves into the theoretical underpinnings of input service credit, dissects the core issues presented in the case, elucidates the tribunal's judgment and its rationale, and clarifies key concepts to provide a comprehensive understanding of this significant ruling.

## Theoretical Framework: The Concept of Input Service Credit

At its heart, the Cenvat (Central Value Added Tax) credit mechanism, which aims to avoid the cascading effect of taxes by allowing manufacturers and service providers to avail credit for the excise duty and service tax paid on inputs used in providing their final goods or services. The fundamental principle is that taxes should ideally be levied only on the value addition at each stage of production or service provision. Rule 2(l) of the Cenvat Credit Rules, 2004 defines "input service" as any service used by a provider of taxable

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service for providing an output service.

This definition, while broad, is inherently linked to the direct nexus between the input service and the output service. The crucial element is that the input service must have a demonstrable connection to the taxable output service being provided by the entity claiming the credit. Several theoretical considerations underpin this concept. Firstly, there must be a clear and direct link between the input service received and the output service provided, implying that the input should contribute to the creation or delivery of the output service. Secondly, the credit mechanism is designed to tax only the value added by the service provider, so allowing credit for services that have no bearing on the output service would distort this principle.

Thirdly, tax jurisdictions generally operate within defined geographical boundaries, and the levy and credit mechanisms are often framed within these territorial limits, raising complexities when services are rendered or utilized across borders. Finally, the Cenvat credit system promotes economic efficiency by preventing the burden of input taxes from being passed on to the final consumer, thus reducing the overall cost of goods and services. The application of these theoretical principles becomes particularly challenging when multinational corporations operate through subsidiaries, leading to inter-company transactions and the question of whether services procured by or provided through these subsidiaries qualify as "input services" for the parent company.

The Issue: Eligibility of Cenvat Credit on Services Provided by Overseas Subsidiaries

The core issue before the appellate tribunal in Tech Mahindra Ltd. Versus Commissioner of Service Tax-I, Pune, revolved around the eligibility of the appellant company (the holding company in India) to avail Cenvat credit of the service tax paid under the reverse charge mechanism on transactions involving its overseas subsidiaries. The transactions were categorized into two models. In Model-I, the appellant directly contracted with overseas customers, providing both export and onsite components of the service with the help of its overseas subsidiaries. Invoices were raised by the appellant from India, and there was no dispute regarding these transactions. However, in Model-II, the overseas subsidiary directly contracted with overseas customers and provided services outside India.

The subsidiary raised invoices and collected payment. Subsequently, the subsidiary raised invoices on the appellant (holding company in India), and funds were transferred, irrespective of the actual value of the services provided by the subsidiary to the overseas subsidiaries to their overseas clients were not **"input services"** for the appellant in India because the appellant had no direct role in providing these services.

Consequently, the Cenvat credit availed on the service tax paid on these Model-II transactions was deemed inadmissible, leading to the denial of **refund of accumulated Cenvat credit** under **Rule 5 of the Cenvat Credit Rules, 2004.** If the appellant had directly contracted with the overseas clients in Model-II as well, but outsourced the onsite service delivery to its subsidiary, would the service tax paid on the subsidiary's charges still be considered eligible for Cenvat credit?

In this hypothetical scenario, the nexus between the input service (onsite service by the subsidiary) and the output service (IT software service provided by the appellant to the overseas client) would be more direct. The subsidiary would be acting as a service provider to the appellant in fulfilling its contractual obligation to the overseas client. In such a case, the service tax paid on the subsidiary's charges could potentially qualify as Cenvat credit, provided other conditions of the Cenvat Credit Rules are met. The key difference from the actual Model-II is the direct contractual relationship between the appellant and the overseas client.

**The Judgment: Affirmation of Denial of Refund**

The appellate **tribunal** upheld the orders of the Commissioner (Appeals) in both sets of appeals (**Batch-I and Batch-II**), effectively denying the refund of the accumulated Cenvat credit claimed by the appellant. In Batch-I Appeals, concerning a refund of Rs. 75,26,04,317/-, the tribunal affirmed the denial, agreeing with the lower authorities that the service tax paid under the reverse charge on services provided by the subsidiaries to clients outside India did not qualify as "input services" for the appellant in India under **Rule 2(l)** of the Cenvat Credit Rules, 2004.

The crucial factor was that the appellant had no role in providing the services rendered by the subsidiaries to their overseas clients. These services were deemed to have taken place entirely beyond the territorial jurisdiction of India, and under **Section 64 of the Finance Act, 1994,** service tax was not leviable on them in the first place. In Batch-II Appeals, involving a refund claim of Rs. 2068,05,21,894/-, while the appellant withdrew a significant portion of this claim (Rs. 1992,79,17,577/-), the remaining claim of Rs. 75,26,04,317/- (overlapping with Batch-I) and an additional amount of Rs. 25,63,77,247/- were also rejected.

The tribunal reasoned that even if the appeals were allowed, the lack of detailed bifurcation

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in the case records and the affidavit regarding which specific amounts pertained to admissible refunds in each individual claim would make the order unimplementable, and an unimplementable order is not sustainable in law.

**Rationale: Lack of Nexus and Territorial Jurisdiction**

The tribunal's rationale for denying the refund in Batch-I appeals rested on two key pillars: the absence of a direct nexus and the principle of territoriality of taxation. The services provided by the overseas subsidiaries to their overseas clients were considered independent transactions in which the appellant in India had no direct involvement in terms of service provision. The intercompany invoices and fund transfers were viewed as financial arrangements between the holding company and the subsidiary, not directly linked to the appellant's output service of providing IT software services to its own overseas clients (under Model-I). Therefore, the service tax paid on these intercompany transactions did not relate to any "input service" used by the appellant for providing its taxable output services.

Furthermore, the services provided by the subsidiaries were wholly rendered and consumed outside the territorial jurisdiction of India. Section 64 of the Finance Act, 1994, stipulates the territorial extent of service tax levy. Since the subsidiaries' services fell outside this ambit, the service tax paid under reverse charge by the appellant on these transactions was deemed not legally leviable in the first instance. Consequently, availing credit and claiming a refund of a tax that was not rightfully payable was not permissible under the Cenvat Credit Rules. In the case of Batch-II appeals, the primary rationale for rejection was the lack of sufficient information to determine the quantum of admissible refund in each individual claim.

The appellant's withdrawal of a substantial portion of the claim and its submission regarding the remaining amount lacked a clear segregation of which amounts in the original refund applications pertained to the inadmissible Model-II transactions and which might relate to other potentially eligible credits. This lack of clarity rendered any order allowing the appeals unimplementable. If the appellant could have demonstrated that the inter-company charges from the subsidiary were directly and solely related to the onsite component of a Model-I contract (where the appellant directly billed the overseas client), would the outcome regarding Cenvat credit eligibility have been different?

In this altered scenario, the inter-company service provided by the subsidiary would have a direct nexus with the appellant's output service under Model-I. The subsidiary would be essentially acting as a sub-contractor for the appellant in fulfilling its obligation to the

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overseas client. In such a case, the service tax paid by the appellant on the subsidiary's charges could potentially qualify as Cenvat credit, as it would be a service used by the appellant for providing a taxable output service. The key difference here is the direct link to a taxable output service provided by the appellant.

**Conclusion**

The appellate tribunal's judgment firmly establishes the necessity of a direct nexus between the input service and the output service for availing Cenvat credit, particularly in intricate cross-border scenarios involving subsidiaries. The ruling underscores that mere financial transactions between a holding company and its overseas subsidiary, without the parent company's direct involvement in the service provision to the ultimate customer outside India, will not qualify the subsidiary's services as eligible input services for the parent.

Furthermore, the decision reinforces the fundamental principle of territoriality in taxation, clarifying that service tax paid on services rendered and consumed entirely outside India is not legally sustainable, thereby precluding the availability of credit and subsequent refund. This judgment carries significant future implications for multinational corporations operating with similar business models, necessitating a careful re-evaluation of their inter-company service arrangements and tax planning strategies to ensure compliance with the established principles of nexus and territoriality in indirect tax laws.

Looking ahead, this decision may raise an important open question: In an increasingly globalized economy where services are often fragmented and delivered through complex international structures, how will tax authorities and judicial bodies further delineate the boundaries of "direct nexus" for input service credit eligibility, especially when technology enables seamless integration of services across borders, even without direct contractual relationships between the parent entity and the end consumer of a subsidiary's service? This evolving landscape will likely require further judicial interpretation to provide clarity and certainty for businesses navigating the complexities of cross-border service provisions and indirect tax obligations.

1. Tech Mahindra Ltd. Versus Commissioner of Service Tax-I, Pune, Service Tax Appeal No. 86917 of 2016