TAX ON INTERMEDIARY SERVICES TO FOREIGN RECIPIENTS: A DEVIANCE FROM DESTINATION BASED TAXATION

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Abstract

Export enjoying tax benefits is common in developing countries and such benefit being denied to one particular service is uncommon. The issue of taxing the “intermediary services” to foreign recipients is not unheard of. It is continued to be taxed by India disregarding destination-based taxation. Although there was no illegality in doing it earlier, with the introduction of GST the state of affairs is not the same anymore. The taxing of intermediaries cannot be perceived similarly as it was in the earlier Indian indirect tax regime. The GST’s promise of destination-based taxation is breached and the aggrieved parties have already knocked on the doors of the judiciary. Judicial scrutiny of the law has not yet been fruitful. The Hon’ble judges could not come to a consensus to resolve this legal issue so far. This paper is an attempt to analyze the controversial provision of Section 13 (8) (b) of the Integrated Goods and Services Tax Act, 2017 in the light of judicial pronouncements and the Constitution of India.

Keywords: Intermediary, export, constitution, destination-based tax, and place of supply

INTRODUCTION

Intermediaries are middlemen who assist the suppliers in their supply. This assistance is in itself considered as a service in India where the intermediaries wear the mask of suppliers and suppliers take the shoes of recipients. In such cases, there are three parties and two supplies involved. One is the supply by the supplier to the recipient through intermediaries and another is the supply of service by the intermediaries to the supplier. There is no issue in taxing the supplier who makes supplies through intermediaries. However, taxing the intermediaries for their services would raise eyebrows in some circumstances which could adversely affect their finances. Such circumstances arise when the intermediary as a service provider makes supply of services to foreign recipients, who in turn make supplies to Indian purchasers. No developing country would prefer to tax its exports. Countries usually have tax concessions or exemptions on the export of services and India is no different. However, intermediaries as service providers to foreign recipients are not given similar treatment to that of other service providers in India and such differential treatment is explicitly backed by a provision. Unlike origin-based taxes, the destination-based tax is based on consumption where tax on service is ought to be levied based on the place of consumption. Taxing the place of origin would be prejudicial to the interests of the intermediaries who provide services to foreign recipients. Thus, it is necessary to scan the provision taxing intermediaries for their services to foreign recipients and verify if it falls within the ambit of legitimate charging powers of Indian tax authorities.
Intermediaries are defined under the Integrated Goods and Services Tax Act, 2017 (hereinafter referred to as ‘IGST’) as brokers, agents, or any person arranging or facilitating the supply of goods or services or both or securities to between two or more persons. IGST explicitly excludes persons supplying goods or services or both or securities on their own account. It is pertinent to note that the definition clause of IGST does not provide definitions that can be applied conclusively in all circumstances. This is evident from the phrase “unless the context otherwise requires” at the beginning of the provision listing down the definitions.\(^1\) The very same provision defines “export of services” too. Five conditions need to be satisfied for services to be called an export of services under IGST:\(^2\)

1. Supplier is located in India
2. The recipient is located outside India
3. Place of supply is outside India
4. Payment received by the supplier in convertible foreign exchange
5. Supplier and the recipient are not merely establishments of a distinct person.

The place of supply of services is the location of the recipient in general.\(^3\) Exports of services are zero-rated supplies.\(^4\) Even after fulfilling all the five conditions listed above, an intermediary located in India providing services to foreign recipients located outside India is not treated as a supplier engaging in the export of services because as per Section 13(8) (b) of IGST, the place of supply for intermediary services is always deemed to be the location of the supplier and not the location of recipient.\(^5\) The intermediary service providers who are denied the benefit of making zero-rated supplies by way of deemed fiction are also made liable to pay tax. This is because such services are now construed to be an intra-state supply of services in India as per Section 8(2) of IGST where the place of supply and location of the supplier are within the same State or Union Territory in India.\(^6\) Intra-state supplies are chargeable to tax under the Central Goods and Services Tax Act, 2017 (hereinafter referred to as ‘CGST’) in India.\(^7\) Section 13(8) (b) of IGST has created a legal fiction where the services provided by the intermediaries to foreigners do not enjoy the benefits given export of services which it would legitimately enjoy in its absence.

The charging section (i.e. Section 5) of IGST provides that Integrated Goods and Service Tax shall be levied on inter-state supplies of goods and/or services.\(^8\) The said section neither covers any levying of tax on intra-state supplies nor labelling any supply as intra-state supply. However, contrary to the charging section, Section 13 (8) (b) read with Section 8(2) of IGST indirectly treats intermediary services as intra-state supply. Such treatment is not authorized by the charging section.

Before the introduction of GST, the determination of place of supply of services were governed by specific rules made in this regard namely “Place of Provision of Service Rules, 2012” (hereinafter referred to as ‘2012 Rules’) that were enacted on June 20, 2012.\(^9\)

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\(^1\) The Integrated Goods and Services Tax Act, 2017 (Act 13 of 2017), s. 2 (13).
\(^2\) Ibid., s. 2(6).
\(^3\) Ibid., s. 13(2).
\(^4\) Ibid., s. 16(1) cl. (a).
\(^5\) Ibid., s. 13 (8) cl. (b).
\(^6\) Ibid., s. 8(2).
\(^7\) The Central Goods and Services Tax Act, 2017 (Act 12 of 2017), s. 9.
\(^8\) supra note 1, at s. 5.
2012, by way of a notification. Although the 2012 Rules are inapplicable now, certain concepts have been borrowed from the said Rules into the IGST framework. The definition of the intermediary under the 2012 Rules is almost the same as the one in IGST but the only difference is that it did not include arranging or facilitating the supply of securities. The determination of place of supply of services (or provision of services as stated in the 2012 Rules) is similar with respect to intermediaries. The place of provision of intermediary service is the location of the service provider. However, the current IGST is slightly different because Section 13 (8) (b) of IGST is applicable only when the location of the intermediary providing services or the location of the recipient of services is outside India. This is not the case for the 2012 Rules which do not contain such conditions.

**CONSTITUTIONAL VALIDITY**

Classification of intermediary services under Section 13(8) (b) of IGST should pass the test of reasonableness under Article 14 of the Constitution of India. It is quite common in the field of taxation law to classify goods and/or services into different categories to decide the taxability and tax rates according to the nature of the goods or services as the case may be. However, such classification cannot be arbitrary and operate selectively to discriminate one particular class or person without a purpose. There is no justification or purpose or reason for not treating the intermediary services in the same manner as other services which are zero-rated supplies.

In the case of *Union of India v. N.S. Rathnam & Sons*, the Hon’ble Supreme Court of India held that the Parliament has extremely wide discretion to classify items into different categories for taxation purposes but such classification should refrain from clear and hostile discrimination against a particular class or person. The Hon’ble Supreme Court while went on to hold that the reasonableness of the classification must be examined on the basis, that when the object of the taxing provision is not to tax certain class (like chemical fertilizers in the said case) all the classes which have the same elements and compositions must not be taxed too. If the ratio discussed in the above case is applied to Section 13(8) (b) of IGST, then one can construe that the said provision fails to pass the test of reasonable classification because the object of GST was to bring destination-based tax on consumption and the said provision does the exact opposite.

Globalization has dismantled license-raj in India. Competitors are to be treated alike unless unequal treatment is required in the public interest. The doctrine of level playing field is a part and parcel of Article 19 (1) (g) of the Constitution of India. Decisions or acts which result in unequal and discriminatory treatment would violate the said doctrine and will be held *ultra vires* Article 19(1) (g) of the Constitution. In these circumstances, India cannot afford to disregard Indian service providers completely. Setting up of foreign units in India will raise investment but it should be done in compliance with the doctrine of level playing field. The make in India campaign is initiative was launched by

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12. *supra* note 1, s. 13(1).
Prime Minister Mr. Narendra Modi in the year 2014 which aims to make India into a manufacturing hub opening the investment doors to businesses abroad. One cannot justify the taxing of intermediary services to foreign recipients in the name of the “Make in India” campaign. Such justification is twisted and misleading. Taxing the intermediaries in India would reduce their business and encourage the foreigners to open liaison offices in India to fill the shoes of Indian intermediaries. Indian service providers will be at loss. Thus such taxes levied in the name of such a campaign are discriminatory and violate Article 14 of the Constitution of India. In the case of Union of India v. International Trading Co. it was held that even matters of Government policy should comply with Article 14 of the Constitution and should pass the test of reasonableness without which it would be declared unconstitutional. Therefore, no unconstitutional law can survive on the shoulders of Government policy.

Intermediary services to foreign recipients, satisfying the conditions of export of services, are treated as local supply (i.e. intra-state) under IGST and such treatment is unconstitutional because the State Governments are not authorized to levy tax on such supply under the Constitution. Article 286 (1) provides that State Government laws cannot impose or authorize the imposition of a tax on the supply of services where such supply takes place outside the state or in the course of export of services out of the territory of India. Thus, CGST levied on intermediary services to the foreign recipient where the place of supply is outside India, is unconstitutional and such levy violates Article 286.

Parliament is also not authorized to make laws that have the effect to treat an export of services as a local supply. Constitution of India provides that it is the exclusive power of Parliament to make laws for taxing the supply in the course of inter-state trade or commerce. Under Article 269A, the Parliament has the power only to formulate the principles of determining the place of supply in course of inter-state trade or commerce. The Constitution nowhere provides that the Parliament has the power to formulate rules for determining the place of supply for export of services. Thus, the treatment of intermediary services under Section 13 (8) (b) of IGST is not authorized by the Constitution of India.

**JUDICIAL SCRUTINY**

In the case of Material Recycling Association of India v. Union of India, the Hon’ble Gujarat High Court was dealing with a petition challenging the validity of Section 13 (8) (b) of the IGST. The Hon’ble High Court on July 24, 2020, held that there was no distinction between the intermediary services provided by a person in India or outside India. Just because, the invoices are raised on the person outside India with regard to the commission and foreign exchange is received in India, it would not qualify to be export of services. The Hon’ble High Court justified the validity of the said provision by citing that a similar situation existed in the service tax regime also and it is a valid law made by the Parliament. The Hon’ble Court did not test

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15 About, Make in India, available at: https://www.makeinindia.com/about (last visited on November 14, 2021).
the provision in the light of Article 269A or 286 or doctrine of level playing field under Article 19 (1) (g) and passed the order sub silentio.

In the case of Dharmendra M. Jani v. The Union Of India,\(^{21}\) the Division Bench of Hon’ble Bombay High Court delivered two different opinions with respect to the constitutional validity of Section 13 (8) (b) of IGST. The Hon’ble Justice Ujjal Bhuyan refused to consider the non-existent Place of Provision of Service Rules, 2012, and non-binding judgments of other High Courts in India which legitimizes Section 13(8) (b) of IGST. The Hon’ble Justice Ujjal Bhuyan held that the said provision is unconstitutional because it violates Article 14, Article 19 (1) (g), Article 269A, Article 286, the IGST, the overall scheme of CGST and it is against the destination-based tax on consumption which is the objective of GST. However, the Hon’ble Justice Abhay Ahuja relied on the Gujarat High Court ruling in Material Recycling Association of India v. Union of India and held that there is reasonable classification with the objective of preventing revenue from escaping and thus does not violate Article 14. The Hon’ble Justice Abhay Ahuja held that the provision in question did not violate any Article of the Constitution and was in compliance with the Scheme of GST. The Hon’ble Justice went on to hold that Parliament has the legitimate power to determine the place of supply as “taxation of supply” is the scheme of GST.

The treatment of intermediary services under Section 13 (8) (b) of the IGST cannot justified or compared with similar treatment in the Service Tax regime that existed before the introduction of GST. Such an approach, if applied to all issues, would backfire because the GST has changed even the fundamentals that existed before it. GST did not supplement the old regime. It replaced the old regime. State legislatures had no right to impose any form of tax on the intra-state supply of services, but now they have that power. Parliament did not have the right to impose any form of tax on the intra-state supply of goods except at the manufacturing stage, now it has that power.\(^{22}\) India should look forward and resolve the issue based on the objectives of the current GST regime instead of holding on to the old tax regime based on origin-based taxation.

Relief to intermediary service providers will significantly reduce the cost of doing business in India, leading to a potential increase in investments as well as foreign exchange, which could be much-needed momentum to navigate the present challenges being faced by the Indian economy due to COVID-19.\(^{23}\) Many exporters in India are facing a lot of pressure due to Covid19 and the GST burden will make them uncompetitive due to the competition from neighbouring nations. The Court’s stand in favour of intermediaries in India would certainly give huge relief.\(^{24}\) While the judiciary is yet to resolve this completely, it would be better if the GST Council empathizes with the suppliers of intermediary

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\(^{21}\) 2021 (6) TMI 563.


services in India and recommends the removal of Section 13 (8) (b) from the IGST.

139TH REPORT OF PARLIAMENT STANDING COMMITTEE ON COMMERCE

The Parliament’s Standing Committee on Commerce studied the impact of Goods and Services Tax (hereinafter referred to as ‘GST’) on exports and on December 19, 2017, submitted a report in that regard. The said Committee suggested that the Indian intermediary services should be treated as exports and should be allowed to enjoy the benefits that come with it. The recommendation was not without reason. The report highlighted the importance of exports in India and stated that foreign trade accounts for 45% of India’s Gross Domestic Product (GDP) and thus the need for an efficacious export framework cannot be overemphasized. The Report also observed that the growth of exports and a strong export ecosystem will be the success mantra for the Make in India campaign.  

The Report while suggesting that the Indian intermediary services to foreign suppliers to be treated as export of services observed that GST is a destination-based tax and such intermediary providing services to overseas suppliers of goods pay IGST at 18% on the commission earned in convertible foreign exchange because the Government of India does not treat their services as “Export of Services”. Even if both supplier and buyer are located outside India, the commission earned for such transaction attracts IGST at 18%. Though the report made its recommendations in the year 2017, nothing has changed so far.

CONCLUSION AND SUGGESTIONS

Tax levied without the sanction of law is theft and no nation would want to steal from its citizens, especially from exporters. The legal fiction created by Section 13 (8) (b) of IGST is alien to the objectives of GST (i.e. destination-based tax on consumption) and fails to comply with various provisions of the Constitution of India. Determination of place of supply must be based on principles that are consistent with the objective of GST. The age-old origin-based taxation is still looming the Indian intermediaries who provide services to foreign recipients and comply with all the conditions for being called as export of services. The judiciary is divided in its opinion on the issue. As there is no uniform solution offered by the judiciary to the issue at hand, it will be interesting to see how the situation unfolds in the future.

As of now, Section 13 (8) (b) of IGST is not scrapped off and it continues to haunt the Indian intermediary who provide services to foreign recipients because of the fictional place of supply that the above-said provision creates. Therefore it is necessary to remove the effect of the said provision at the earliest so that Indian intermediaries which fulfil the conditions for export of services do not miss the benefits of export because of the fictional place of supply. For the above-said purposes, the following suggestions are made to the Parliament:-

1. Section 13 (8) (b) of IGST may be omitted; and

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26 Ibid., at 21.
2. A new sub-section may be added to Section 13 of IGST providing that the Place of Supply of Indian Intermediary services to foreign recipients will be the location of the service recipient and not the location of such intermediaries.

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