

Optimizing Input Tax Credit Distribution through ISD Mechanism-Part 1: Conceptual Overview and SAP System Integration

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Abstract: *The Input Service Distribution (ISD) mechanism in India, established under Section 2(61) of the CGST Act, 2017, serves as a crucial mechanism for distributing the Input Tax Credit (ITC) for common services used across multiple business units. With the mandatory introduction of the ISD provisions from April 1, 2025, as per notification No. 16/2024 – Central Tax, the mechanism ensures that GST credits on common services are correctly apportioned and distributed to the various branches of an organization. This paper, the first in a two-part series, explores the key principles of ISD, its applicability, and the steps involved in its practical implementation within businesses. It focuses specifically on the technical implementation of ISD within SAP systems, including service activation and system preparation, given its widespread use among large Indian organizations. The functional configuration and operational execution aspects will be addressed in the second part of the series. Additionally, this paper illustrates case studies and examples to highlight the nuances of ITC distribution and explores the integration of ISD in SAP systems to streamline compliance and improve operational efficiency.*

Keywords: Input Service Distribution (ISD), India GST, Input Tax Credit (ITC), SAP Solutions for ISD, CGST Compliance, SAP CIN Implementation

1. Introduction

Input Service Distribution (ISD) is a tax mechanism used by organizations in India that have multiple branches or business units. According to Section 2(61) of the CGST Act, 2017, an "Input Service Distributor (ISD)" is an office that receives tax invoices for common input services and then distributes the credit for central tax, state tax, integrated tax, or union territory tax paid on those services to the branches or business units that share the same Permanent Account Number (PAN) as the ISD office. It's important to note that ISD only applies to the distribution of credit related to services, not goods (whether inputs or capital goods). A separate ISD registration is mandatory under the ISD provision and distribution of the input tax credit to the receiving branches must in the proportional ratio of their turnover.

To distribute the input tax credit, an ISD must issue an ISD invoice as prescribed in Rule 54(1) of the CGST Rules, 2017. The invoice must clearly indicate that it is for the sole purpose of distributing input tax credit. The input tax credit available for distribution in a given month must be distributed within the same month.

Historically, the provision of ISD was not mandatory. However, the govt has made ISD provisions mandatory from April 1, 2025, via notification No. 16/2024 – Central Tax, dated the 6th August 2024. This policy shift has significant implications for businesses with shared service structures, requiring not only a legal understanding of the ISD framework but also the ability to operationalize it effectively within their financial and tax systems.

This paper is the first in a two-part research series that examines the key principles of ISD, its applicability, and the steps involved in its practical implementation of Input Service

Distribution (ISD) within enterprise environments, with a focus on SAP systems, given their widespread use among large Indian organizations. Part 1 focuses on the legal framework, core concepts, and technical setup required to enable ISD, providing a foundation for understanding both regulatory obligations and system preparedness.

Part 2 will build on this foundation by addressing the functional and operational aspects of ISD, including configuration, execution, and internal controls for Input Tax Credit (ITC) distribution within an ERP system.

By combining regulatory understanding with system-level application, this series aims to inform both academic research and industry practice in the areas of tax compliance, governance, and digital transformation under India's evolving GST regime.

2. Literature Review

The history of Goods and Services Tax (GST) in India goes over two decades and is marked by significant efforts to simplify and unify the country's indirect tax system. Prior to GST, India had a complex structure of multiple taxes, including Central Excise Duty, Service Tax, and Value Added Tax (VAT), each levied by different authorities at different levels (federal, state, municipal etc.). This created a cascading effect of taxes, inefficiencies, and difficulties for businesses operating across state boundaries. Indian govt has realized the problem in the beginning of 21st century and started working on a common indirect law. The idea of implementing GST in India was first proposed in 2000 by the then prime minister of India Mr. Atal Bihari Vajpayee. The government has formed an Empowered Committee of State Finance Ministers to explore the feasibility of a single indirect tax system. In 2006, the then Finance Minister introduced the concept of GST in

the Union Budget, laying the foundation for future reforms.

By 2010, the government drafted the first GST Bill, which proposed a dual GST structure, where both the central and state governments would tax the same transaction, with credit mechanisms to avoid double taxation. It wasn't until 2014 that Parliament passed the Constitutional Amendment Bill, allowing both central and state governments to levy GST. This created a unified tax structure across India. In 2016, the 101st Constitutional Amendment Act was enacted, which formally provided the legal framework for GST. This led to the formation of the Goods and Services Tax Council, a body consisting of both central and state govt. representatives to oversee the implementation and operational aspects of GST. The GST law was finalized, and on July 1, 2017, GST was officially launched, replacing the previous tax structure with a single, unified tax system. GST was designed to simplify the taxation process and create a seamless national market by applying a dual tax model: Central GST (CGST) for intra-state transactions, State GST (SGST) for intra-state transactions, and Integrated GST (IGST) for inter-state transactions.

Since its introduction, the GST system has undergone continuous reforms to address challenges faced by businesses and taxpayers. The government introduced measures to simplify the filing process, adjust tax rates, and improve transparency. The implementation of the GST Network (GSTN) platform has helped streamline compliance and reduce paperwork. In addition, the government has made efforts to ensure that businesses pass on the benefits of reduced taxes to consumers through anti-profiteering measures.

Despite some initial challenges, the government's ongoing efforts have focused on making the system more business-friendly, particularly for small and medium-sized enterprises (SMEs), and further rationalizing the tax rates to reduce complexity. Technology and data analytics are also being increasingly used to enhance compliance and detect tax evasion. As the GST system continues to evolve, it is expected to contribute significantly to the growth of India's economy by making tax administration more transparent, efficient, and equitable.

ISD is another initiative by the government to improve, standardize, and simplify the distribution of Input Tax Credit (ITC) on common expenses incurred by an organization with multiple branches, where these expenses benefit more than one branch of the business.

3. Applicability of ISD

The Input Service Distribution (ISD) mechanism in India applies to legal entities with multiple branches that incur common service expenses. In many businesses, the head office is in one place, while the other branches are registered in different locations. The head office often purchases

services that are used across all units, and invoices for these services are raised to the head office. However, since the head office does not make any taxable supply, it cannot use the accumulated Input Tax Credit (ITC) for these services. Since these expenses benefit multiple branches, the ITC on common invoices should be distributed among the consuming units, which is where the ISD mechanism comes in.

Here are some key points about the ISD mechanism:

- **Separate Registration:** The ISD must have a separate registration. It cannot discharge any tax liability but is only responsible for distributing the credit on common service expenses. If the ISD is also involved in other commercial activities, it must register as a normal taxpayer in addition to the ISD registration.
- **Common Taxable Services:** The ITC distribution under ISD applies only to common taxable services, such as accounting, information technology, or legal services. ISD can't receive any invoice with Reverse charge.
- **Receiving Tax Invoices:** The ISD receives tax invoices for common services used by multiple branches.
- **Same PAN:** All branches involved in the ISD mechanism must be under the same Permanent Account Number (PAN).
- **Monthly Filing:** ISD must file GSTR 6 monthly to report all ISD invoices issued. The recipient branches can claim the ITC in their GSTR 3B returns.

4. Input Tax Credit (ITC) distribution by Input Service Distribution (ISD)

Section 20 of the CGST Act, 2017, outlines the rules for ITC distribution by an Input Service Distributor (ISD):

- **Timely Distribution:** The credit must be distributed within the same month it is received, and the total ITC distributed cannot exceed the available input credit.
- **Recipient Branches:** ITC must be distributed to the branches that have received the services.
- **Proportional Allocation:** The distribution is based on the turnover of the respective branches, ensuring a fair and proportional allocation of the credit.
- **Tax Type Allocation:** The distribution of ITC depends on the type of tax—CGST, SGST, IGST, or UTGST—based on the location of the branches and the ISD.

These rules help ensure that ITC is distributed correctly and fairly across branches, in line with the applicable tax regulations.

Let's understand this with examples. Assume XYZ limited has a HQ in Mumbai, registered as ISD office. XYZ has 4 other branches in Pune, Delhi, Kolkata, and Chennai.

Example 1: Company HQ has incurred an audit expense of INR 100000 and paid GST of INR 18000 e.g. 18% (9% CGST + 9% SGST) on the expense. The audit was for Pune and Delhi location. The below will be the ITC distribution:

ISD Branch	Receipt Branch	Branch Turnover	Total Turnover	Ratio (Branch Turnover/ Total Turnover)	ITC Amount (Total Credit*Ratio)	Receipt Tax Type
Mumbai	Pune	6000000	10000000	60%	10,800	CGST+SGST
Mumbai	Delhi	4000000	10000000	40%	7,200	IGST

Example 2: Company HQ has received a software service invoice INR 1000000 and paid GST of INR 180000 e.g. 18%

(9%CGST + 9%SGST) on the expense. All Branches have used the software. The below will be the ITC distribution:

ISD Branch	Receipt Branch	Branch Turnover	Total Turnover	Ration (Branch Turnover/ Total Turnover)	ITC Amount (Total credit*Ratio)	Receipt Tax Type
Mumbai	Pune	6000000	20000000	30%	54000	CGST+SGST
Mumbai	Delhi	4000000	20000000	20%	36000	IGST
Mumbai	Kolkata	8000000	20000000	40%	72000	IGST
Mumbai	Chennai	2000000	20000000	10%	18000	IGST

Please note that ISD invoice issued by ISD branch must indicate that this invoice is issued for distribution of Input tax credit under section 20 of ISD provision of CGST Act, 2017.

5. Exploring SAP Solutions

The Government of India, through Notification No. 16/2024 dated August 6, 2024, has made compliance with ISD provisions **mandatory** from April 1, 2025. This change in policy has major implications for businesses that operate shared service models, as it demands both a clear understanding of the ISD regulations and the capability to implement them efficiently within their financial and tax systems to optimize the Input Tax Credit through ISD distribution mechanism.

SAP, a widely used ERP system among large enterprises in India, provides a standard solution for managing ISD under its India Localization support package. The implementation of ISD in SAP is typically divided into two main phases: *Technical Implementation* and *Functional Implementation*.

Technical Implementation includes Prerequisites and Applying the required SAP OSS notes to enable the functionality in SAP. It also includes Activation of services for ISD in SAP.

Functional Implementation is split into two key steps: Functional Configuration, and Official Document Number (ODN) configuration.

Finally, process to execute the functionality in SAP to distribute and post ITC from ISD office to its branches.

This paper, the first in a two-part series, covers the *Technical Implementation* of ISD within SAP systems, including service activation and system preparation. The *Functional Configuration and Operational Execution* aspects will be addressed in the second part of the series.

6. Technical Implementation

This is the first step in implementing the ISD solution in SAP. It involves setting up the required prerequisites and applying the necessary SAP OSS notes to enable the required functionality in SAP.

1) Prerequisites:

It is important to make sure the system meets all the prerequisite requirements. The necessary steps should be taken to implement the required minimum prerequisites:

a) Minimum support pack:

To implement Input Service Distribution, the SAP system must be at least on the below support pack mentioned in SAP note 1175384. SAP does not support India Logistics and Indirect Taxes (CIN) on platforms below the specified support pack.

AP_APPL Release	Support Pack
SAP ERP 6.0 (600)	SP 26
EHP2 FOR SAP ERP 6.0 (602)	SP 16
EHP3 FOR SAP ERP 6.0 (603)	SP 15
EHP4 FOR SAP ERP 6.0 (604)	SP 16
EHP5 FOR SAP ERP 6.0 (605)	SP 13
EHP6 FOR SAP ERP 6.0 (606)	SP 14
EHP6 FOR SAP ERP 6.0 for HANA (616-SAP HANA)	SP 08
EHP7 FOR SAP ERP 6.0(617)	SP 07
EHP8 FOR SAP ERP 6.0(618)	SP 02
SAP S/4HANA ON-PREMISE 1511	SP 02

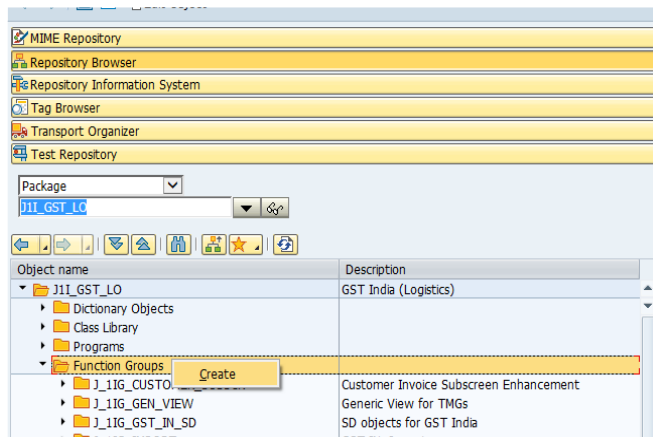
Please note: SAP systems with a support pack higher than the one mentioned below will support the new ISD solution described in this paper. If the SAP system has a lower support pack, a list of necessary OSS notes must be implemented to enable the required functionality of the new ISD solution from SAP.

AP_APPL Release	Support Pack
SAP ERP 6.0 (600)	SP 31
EHP2 FOR SAP ERP 6.0 (602)	SP 21
EHP3 FOR SAP ERP 6.0 (603)	SP 20
EHP4 FOR SAP ERP 6.0 (604)	SP 21
EHP5 FOR SAP ERP 6.0 (605)	SP 18
EHP6 FOR SAP ERP 6.0 (606)	SP 22
EHP6 FOR SAP ERP 6.0 for HANA (616-SAP HANA)	SP 13
EHP7 FOR SAP ERP 6.0(617)	SP 17
EHP8 FOR SAP ERP 6.0(618)	SP 11

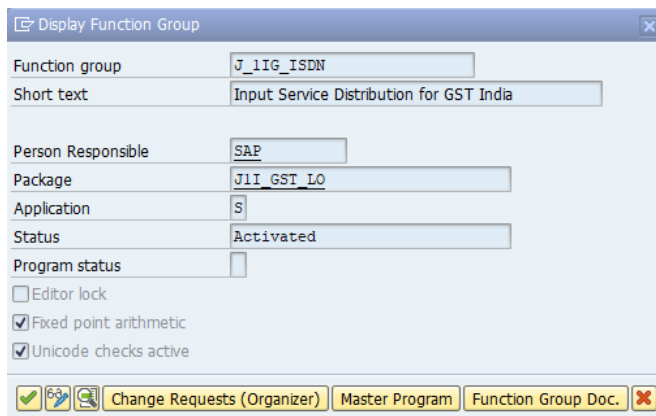
b) Create Functional Group:

It is mandatory to create the ISD function group, J_11G_ISDN, before starting the ISD implementation. All other ISD-related customizations are handled within this function group. Below are the steps to create the J_11G_ISDN function group.

- Execute transaction code SE80 and enter the package name "J11_GST_LO". Click on "Display."
- Next, expand the "Function Groups" node, right-click, and select "Create" to create a new function group, as shown in the screenshot below.



- A new window will open. Enter the function group name as "J1I_GST_IN_SD" and the short description as "Input Service Distribution for GST India."
- Ensure that the package is set to "J1I_GST_LO". Save the settings as shown in the screenshot below.



2) Implement Necessary SAP Notes to Activate Functionality:

The next step is to ensure that the required SAP notes are implemented in the SAP system. This includes verifying that the necessary data dictionaries are created and that the required OSS notes are applied.

Please note: Some of the notes may already be implemented in your SAP version due to a higher support pack being installed. However, it is still recommended to check that all necessary technical functionality is available in your SAP system.

a) Data Dictionary:

SAP introduced a new standard solution for ISD in 2018 and updated some of the existing SAP tables with additional data dictionary objects. To check the applicability of these additional data dictionary objects, please refer to SAP note 2620349 for ECC clients and SAP note 2676848 for SAP S/4 Hana clients.

If your SAP support pack is lower than the required version for these OSS notes, please implement the SAP notes by following the instructions provided in the notes.

b) Implement OSS Notes for new ISD functionality:

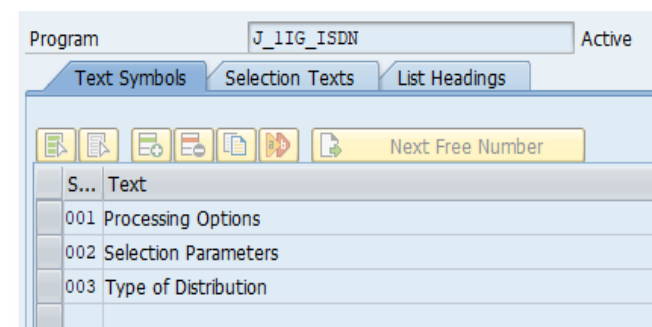
Perform the following manual steps as outlined in OSS note 2621654 (for ECC Clients) or 2677060 (for S/4 Hana) to enable the new ISD functionality in SAP.

Please note: Some of the notes may already be implemented in your SAP version due to a higher support pack being installed. However, it is still recommended to check that all necessary technical functionality is available in your SAP system.

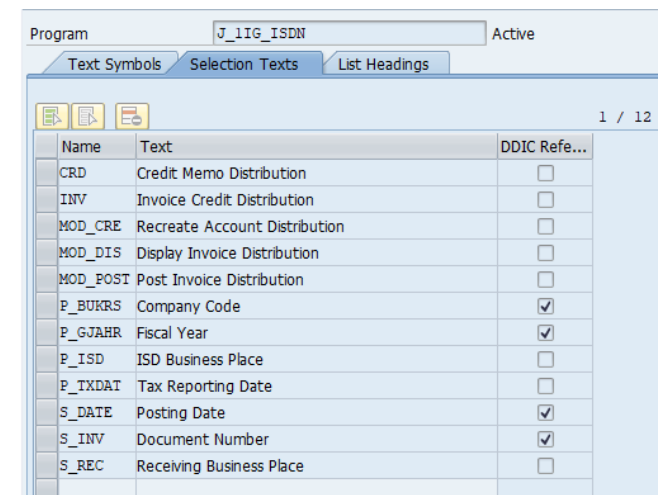
Creation of Text elements: Execute transaction SE38 and enter the program name as 'J_1IIG_ISDN'. Select 'Text elements' and then click on 'Change'.

In Text symbols, please enter the followings:


- 001: Processing Options
- 002: Selection Parameters
- 003: Type of Distribution



In Selection Texts, check the following objects. Save and activate.

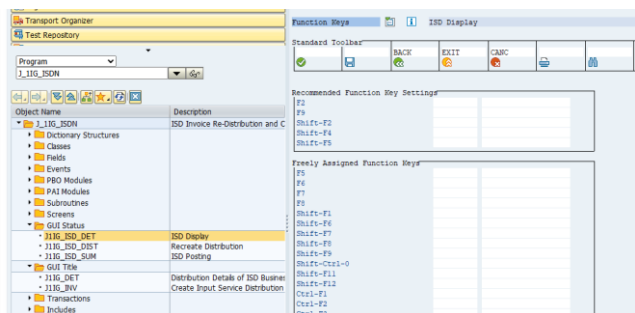


- **Creation of GUI status for objects 'J1IIG_ISD_DET', 'J1IIG_ISD_SUM', and 'J1IIG_ISD_DIST':** Execute transaction SE38 and enter the program name as 'J_1IIG_ISDN' and select 'Change'.

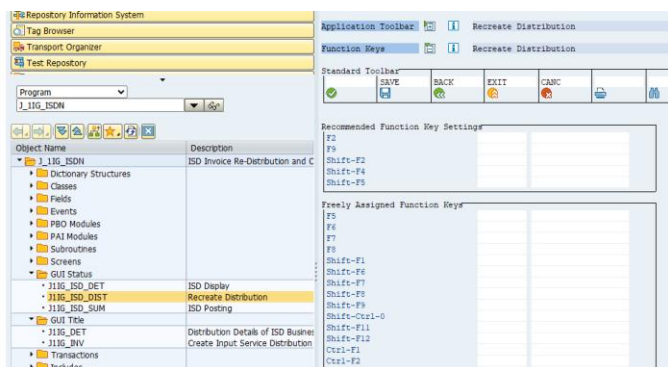
From the toolbar, select 'Display Objects List' , expand 'GUI Status' and right client to create the followings:

Status	Short Text
J1IIG_ISD_DET	ISD Display
J1IIG_ISD_DIST	Recreate Distribution
J1IIG_ISD_SUM	ISD Posting

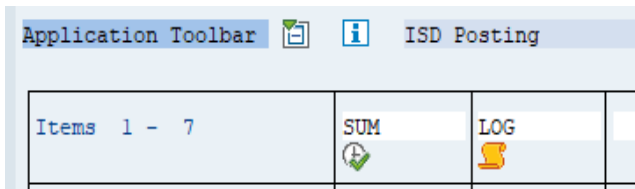
Select 'J1IG_ISD_DET' and 'Update the 'Function Keys' as 'BACK', 'EXIT' & 'CANC', Save and activate.



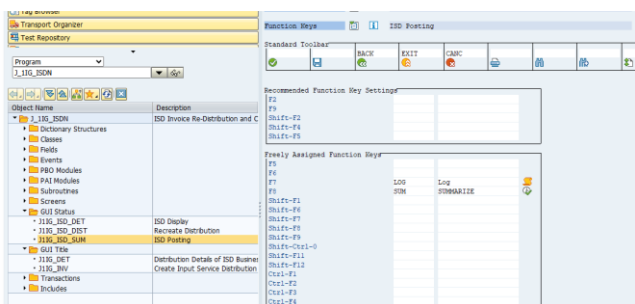
Select 'J1IG_ISD_DIST' and 'Update the 'Function Keys' as 'SAVE', 'BACK', 'EXIT' & 'CANC', Save and activate.




Select 'J1IG_ISD_SUM' and 'Update the application toolbar as 'SUM', and 'LOG', Save and activate.



Select 'J1IG_ISD_SUM' and 'Update the 'Function Keys' as 'BACK', 'EXIT' & 'CANC', and assign Function Keys F7 – LOG, F8 – SUM. Save and activate.



- **Creation of GUI Title objects 'J1IG_DET', and 'J1IG_INV':** Execute transaction SE38 and enter the program name as 'J_1IG_ISDN' and select 'Change'.

From the toolbar, select 'Display Objects List' , Expand 'GUI Title' and right client to create the followings:

Status	Short Text
J1IG_DET	Distribution Details of ISD Business Place Invoices
J1IG_INV	Create Input Service Distribution Invoice

- **Creation of Transaction 'J1IG_ISDN':** Execute transaction SE93, enter "J1IG_ISDN" and select 'Create'. In the pop-up, enter "GST IN: ISD Distribution & Posting" as 'Transaction text' and select program "J_1IG_ISDN". Ensure the following details are maintained and save.

Transaction code	J1IG_ISDN
Package	J1I_GST_LO
Transaction text	GST IN: ISD Distribution & Posting
Program	J_1IG_ISDN
Selection screen	1000
Start with variant	
Authorization Object	
Values	
Classification	
Transaction classification	
<input checked="" type="radio"/> Professional User Transaction <input type="radio"/> Easy Web Transaction <input type="checkbox"/> Pervasive enabled	
Service	
GUI support	
<input checked="" type="checkbox"/> SAPGUI for HTML <input checked="" type="checkbox"/> SAPGUI for Java <input checked="" type="checkbox"/> SAPGUI for Windows	

3) Activation of Service

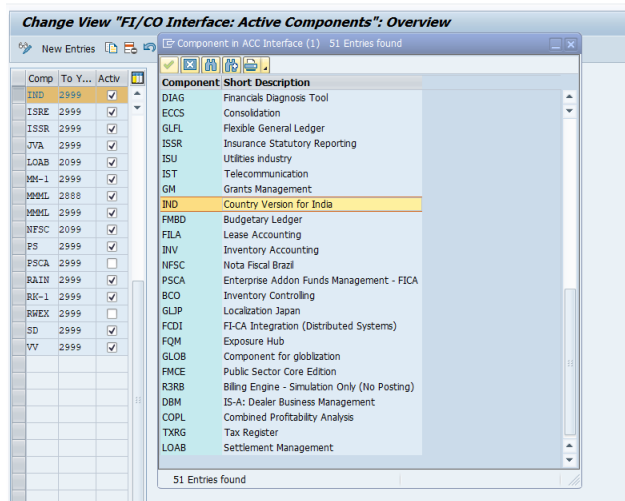
Below are the configuration steps in SAP to activate the latest India Localization solution. This will also activate ISD localization for India.

a) Activate Country Version for India:

Follow the IMG path below to activate the India localization component in SAP:

IMG Path: SPRO → IMG → Financial Accounting → Financial Accounting Global Settings → Tax on Sales/Purchases → Basic Settings → India → Activate Local Version India for Specific Fiscal Years.

SAP Field	Value	Usage
Component	IND	Country Version for India
To Year	2999 (Default)	The End Year to keep functionality activated.
Activate Flag	Tick	Tick to activate the localization functionality

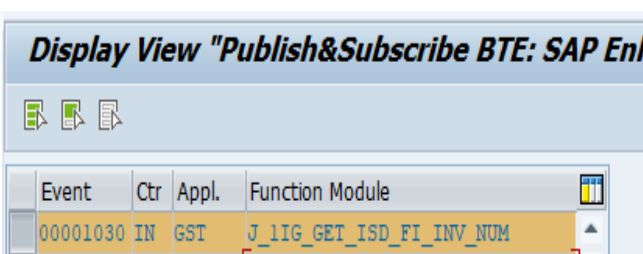


b) Activate Business Transaction Event:

Follow the IMG path below to activate the Business Transaction Event (BTE) for India Localization:

IMG Path: SPRO → IMG → Financial Accounting → Financial Accounting Global Settings → Tax on Sales/Purchases → Basic Settings → India → Activate Business Transaction Events.

SAP Field	Value	Usage
Event	00001025 and 00001030	These are specific events in the program to call additional piece of code.
Country	IN	ISO code of country for Applicability
Application	CIN/GST	Application Indicator
Function Module	J_1IG_INPUT_SERVICE_DISTRIBUTE/J_1IG_GET_ISD FI INV_NUM	Alternative program to process



7. Result

Once all the necessary steps outlined in the technical implementation section are completed, ISD services are activated in SAP. At this stage, the system is ready for the functional configuration required for ISD implementation.

The second part of this paper, titled “Optimizing Input Tax Credit Distribution through ISD Mechanism – Part 2: Functional Configuration and Operational Execution in SAP,” covers the functional setup and execution process. It can be found in the same journal.

8. Conclusion

The ISD mechanism plays a vital role in enabling the fair and efficient distribution of Input Tax Credit (ITC) for organizations with multiple branches in India. By allowing central office to allocate GST credits (ITC) on common services, ISD supports both compliance and operational alignment across business units. With ISD becoming mandatory from April 1, 2025, businesses must ensure they have the technical capabilities in place to implement it effectively.

This paper outlined the legal framework and technical steps needed to activate ISD within SAP systems, including prerequisite checks, OSS note application, and service activation. These steps form the foundation for seamless ITC distribution, enhancing both tax compliance and system efficiency. The second part of this series will focus on the functional configuration and operational execution required to complete the ISD setup. As India's GST system continues to evolve, integrating such mechanisms within ERP platforms will be key to ensuring transparency, automation, and sustained growth for businesses.

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