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ANALYSIS OF GST SCHEME FOR EXPORT OF INTERMEDIARY SERVICES

ABSTRACT

India has undergone a series of developmental changes in taxation that has contributed to the evolution of the Goods and Services Tax framework as we know it today. The most consistent thing during this growth has been legislature's endeavour to create a comprehensive indirect taxation scheme to lessen the burden on both the supplier of services as well as the consumers. India has been persistent in its approach to not tax exports to create a level-playing field for domestic suppliers in international market. However, export of intermediary services has been excluded from this benefit and suppliers of intermediary services are still getting taxed. Recently, this controversy was brought to light again by the Bombay High Court where the strong stance was observed against this anomaly. By way of this paper, it is proposed that taxation of export of intermediary services defies constitutional, legal and commercial logic. This paper develops around the idea that the operation of provisions in the IGST Act is doing more harm than good and this situation warrants government intervention to put this controversy to rest in favour of supplier of intermediary services.

TABLE OF CONTENTS

INTRODUCTION **3**

PART I: LEGISLATIVE COMPETENCE AS PER CONSTITUTION **4**

Judicial review of Tax policies 4

IGST vis-à-vis Article 286 6

PART II: FUNDAMENTAL RIGHTS OF INTERMEDIARY SERVICE PROVIDERS UNDER THE IGST ACT **7**

History of taxation of export of intermediary services 9

IGST Act vis-à-vis Article 14 15

Class Discrimination within Intermediary Services 18

PART III: EXTRA-TERRITORIAL OPERATION **19**

PART IV: CONSTRUING THE BEST PRACTICES **22**

Treatment of Export of Services Globally 23

Scope of Intermediary Services 24

PART V: CONCLUDING REMARKS **27**

Classification of Supply – Section 8(2) or Section 7(5)? 27

Constitutional, Legal and Commercial Viability of the Present Framework 28

Bibliography **30**

INTRODUCTION

The courts have examined the issue of supply of services abroad on various occasions, and so far, they have upheld the constitutionality of the legislative provisions in relation to it. A two-judge bench of Bombay High Court analyzed this issue in a recent judgment,[1] wherein the transaction involved was a situation where a supplier provided intermediary services with respect to certain goods to a recipient located outside India and subsequently, this overseas recipient sold the goods to the Indian customer directly. Here, out of the amount paid to the overseas recipient, a commission was paid in convertible foreign currency to the supplier of services. Justice Ujjal Bhuyan tipped the scale against the constitutionality of taxing provisions, whereas Justice Abhay Ahuja presented a dissenting opinion.

Generally, exports are exempted from tax. However, by virtue of section 13(8) read with section 8(2) of the Integrated Goods and Services Tax Act, 2017 **("IGST Act")**, export of intermediary services incurs GST liability. The current scheme of the IGST provides for taxation of supply of services which should have been otherwise exempt. It begins with the general rule that the location of supply is the location of the recipient of goods or services, but subsections (3) to (14) of Section 13 carve out exceptions to this rule. The effect created thereafter is that although the recipient of some services is located outside India, the place of supply will be the location of the supplier (i.e., within India). This is done to specifically bring certain supplies within the tax net.

Section 13(8) states that "place of supply" of intermediary services is the location of supplier, and section 8(2) states that in cases where "place of supply" and "location of supplier" are in the same State or Union Territory, the supply is treated as intrastate supply. And thus begins the curious conundrum of deeming fiction, because when for any prudent person, the transaction is in the nature of export of services, the IGST Act considers it as a local supply. This is because the two factors that determine the nature of supply (place of supply and location of supplier) will always be the same. So, when a supplier renders intermediary services to a foreign recipient, and that foreign recipient sells that good to a customer in India, the cross-border transaction is treated as intra-state supply. It is widely understood and accepted that the Parliament can legislate on laws

[1] *Dharmendra M. Jani v Union of India* (2021) SCC OnLine Bom 839

regarding Goods and Services Tax **("GST")** on recommendations of the GST council, but it is the constitutional provisions that determine the scope as well as limits of levying of GST on such transactions.

This paper construes that scope and examines whether the deeming fiction created is within the constitutional framework and if it derives its legislative competence from the Constitution of India ("**Constitution**"). Part I of this paper analyzes the IGST provisions on the cornerstone of the Constitution. It starts by examining the pattern of judicial review in India with respect to tax legislations to understand the factors considered while examining constitutional validity of a tax statute. Then it examines whether the deeming fiction in the IGST Act is in consonance with Article 286 of the Constitution. Part II of this paper traces legislative competency of IGST Act through the lenses of Article 14 of the Constitution. It sets forth the history of taxing the export of intermediary services and then examines current provisions of IGST Act on the dual test of arbitrariness of Article 14. Part III of this paper contemplates the extra-territorial operation of the deeming fiction to scrutinize whether such extra-territoriality is permissible. Part IV highlights best practices for taxing export of services across the globe. This is done by examining global trends in levying tax on intermediary services and identifying the intention of legislature behind the existing framework. Part V of the paper deals with the question of whether such supply can be classified as inter-state under section 7(5) instead of intra-state under 8(2) of the IGST Act. The paper then concludes with discussion on the consequences of continuing with the present framework.

PART I: LEGISLATIVE COMPETENCE AS PER CONSTITUTION

JUDICIAL REVIEW OF TAX POLICIES

Judicial review by Indian courts has evolved in three dimensions: first, to demonstrate fairness in administrative action; second, to preserve constitutionally guaranteed fundamental rights; and third, to decide on matters of legislative competence between the center and states. When the constitutionality of a legislation is questioned, the court has to presume that the legislature knows and rightly understands its own people's interests and its laws are tailored to resolve problems

faced by people, and therefore, its discriminations are based on sufficient justifications.[2] In the matter of *State of Madhya Pradesh* v. *Rakesh Kohli and Anr.*[3], the Apex Court coined certain guiding principles to be kept in mind while dealing with the legitimacy of taxation statutes, which are as follows:

i. The constitutionality of a legislation by the Parliament or a State Legislature is always to be presumed.

ii. A Legislation cannot be struck down on the mere ground of it being arbitrary or irrational; its invalidity has to be backed by some constitutional infirmity.

iii. Since the Parliament and State Legislatures are bound to take care of the needs of people, they represent and devise policies as per people's requirements, the courts are not concerned to examine the wisdom or unwisdom of the law.

iv. In the domain of taxation, legislators have more leeway with regards to classification of policies.

The Supreme Court has reiterated on multiple occasions that economic policies contain an element of trial and error, and that as long as the trial and error is genuine and with the greatest intentions, such policies cannot be challenged as arbitrary, capricious, or unlawful.[4] The court cannot overturn a policy decision made by the government just because it believes that another policy option would have been fairer, better, more scientifically or logically sound. However, the court could intervene only if the policy legislated is patently arbitrary, discriminatory, or malicious.[5]

The legislature has greater freedom on issues of taxes and economic policies than on aspects of civil rights such as freedom of speech, religion, and so on. The legislature is granted considerable

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[2] *M H Quareshi v State of Bihar* (1959) 1 SCR 629

[3] *State of Madhya Pradesh v Rakesh Kohli & Anr* (2012) 6 SCC 312

[4] *Arun Kumar Agrawal v Union of India* (2013) 7 SCC 1

[5] *Dhampur Sugar (Kashipur) Ltd v State of Uttaranchal* (2007) 8 SCC 418

leeway in economic matters since they are complex, and no straitjacket formula is appropriate.[6] From the precedents it can be well understood that the judicial authority to review the taxation policies is limited and remedy can be granted in either of two circumstances: if a legislation is enacted in contravention to legislative competence or if the rights of person enshrined under Part III of the Constitution are affected.[7]

IGST VIS-À-VIS ARTICLE 286

By joint reading of Section 13(8)(b) and Section 8(2) of the IGST Act, it can be reckoned that when an intermediary supplies a service to a person outside India, the tax on the same is covered under the ambit of intra-state supply by way of deeming fiction. It is prudent to examine the validity of such provisions vis-à-vis the constitution. The relevant provision in this aspect is Article 286, which is reproduced below:

> *"**286.** (1) No law of a State shall impose, or authorise the imposition of, a tax on the supply of goods or of services or both, where such supply takes place—*
>
> *(a) outside the State; or*
>
> *(b) in the course of the import of the goods or services or both into, or export of the goods or services or both out of, the territory of India.*
>
> *(2) Parliament may by law formulate principles for determining when a supply of goods or of services or both in any of the ways mentioned in clause (1)."*[8]

Article 286 in its clause (1) explicitly prohibits states from imposing or authorizing the imposition of tax when (a) inter-state supply takes place, and when (b) supply in the course of import or export takes place. In clause (2), the constitution empowers the Parliament to decide principles for determining the time or event as to when inter-state supply or supply in the course of import or export takes place. After reading the above-mentioned articles harmoniously, there is no shadow

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[6] *R K Garg and Ors v Union of India (UOI) and Ors* (1981) 4 SCC 675

[7] *Union of India v Exide Industries Ltd* (2020) 425 ITR (SC) 1

[8] The Constitution of India 1950, Article 286.

of a doubt that the constitution intended Parliament to legislate on laws on interstate supply and states to legislate on intrastate supply only.

The scheme of GST is of a consumption-based tax as opposed to origin-based tax.[9] The fundamental objective of the IGST Act is to make provisions for imposition and collection of tax on inter-state supply by the Central Government. It is evident that the State Legislatures cannot formulate laws for taxation on exports. However, a supply of services by an intermediary to a business outside India, which should be regarded as an export of services, has been deemed to be an intra-state supply through the IGST Act.

For intra-state transactions, State Goods and Services Tax Act, 2017 is applicable. This becomes problematic from the constitutional perspective because although the supplier is rendering his services outside India, the states get the authority to impose a tax on the services of the supplier and such taxation is prohibited.[10] Therefore, the effect created by provisions of the IGST Act is contrary to Article 286(1) when by operation of IGST provision, states are empowered to tax export of supply. It is upon the legislature to rectify a situation that goes contrary to the cornerstone of the constitution.[11]

PART II: FUNDAMENTAL RIGHTS OF INTERMEDIARY SERVICE PROVIDERS UNDER THE IGST ACT

[9] 'Goods and Service Tax (GST) Concept & Status' (*Central Board of Indirect Taxes and Customs*, 1 February 2019) Pg 12 <https://www.cbic.gov.in/resources/htdocs-cbec/gst/01022019-%20GST-Concept%20and%20Status.pdf> accessed 20 October 2021

[10] *GVK Industries Limited v ITO* (2011) 332 ITR 130; *Central India Spinning and Weaving and Manufacturing Co Ltd v Municipal Committee, Wardha* AIR 1958 SC 341; *State of Travancore, Cochin v Bombay Co Ltd* AIR 1952 SC 366

[11] *Income Tax Officer v M K Mohammed Kunhi* (1969) 2 SCR 65

GST is a consumption-based destination tax that is levied in the case of supply of goods and services where consumption of such supply takes place i.e., location of the recipient.[12] However, section 13(8)(b) allows a situation wherein the location of export of intermediary services is the location of the supplier instead of the recipient. Then, by virtue of Section 8(2) a cross-border supply is treated as a local supply. This treatment of intermediary services leads to extra-territorial operation of provisions of a central Act and this situation is prohibited in India.[13]

The present issue is regarding such operation of provisions that the export of services is deemed as local supply. The relevant provisions of the IGST Act are reproduced below:

> *"**2(6)** defines 'export of services' means a supply of any service where:*
>
> *i. The supplier of service is located in India;*
>
> *ii. The recipient of service is located outside India;*
>
> ***iii. The place of supply of service is outside India;***
>
> *iv. Payment for such service has been received by the supplier of service in convertible foreign exchange; and*
>
> *v. The supplier of service and the recipient of service are not merely establishments of a distinct person in accordance with Explanation 1 in section 8.*
>
> . . .
>
> ***2(13)** 'intermediary' means a broker, agent, or any other person who facilitates supply of goods or services between two or more persons and does not include a person who supplies goods or services by himself."*

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[12] 'Circular 90/09/2019-GST' (*Central Board of Indirect Taxes and Customs*, 18 February 2019)

https://www.cbic.gov.in/resources//htdocs-cbec/gst/circular-cgst-90.pdf;jsessionid=7D2467955A3E03067727C9DEF5B6CE7E accessed 20 October 2021

[13] *All India Federation of Tax Practitioners v Union of India* (2007) (7) STR 625

Gujarat High Court considered the issue of in the case of *Material Recycling Association of India v. Union of India and OR's.*,[14] and held that because the third condition, i.e., the place of supply must be outside India, is not satisfied, intermediary services do not qualify as 'export of services'. However, it is only in pursuance of section 13(8)(b) that intermediary services do not satisfy the condition. When a provision is challenged on the basis of it being discriminatory, its support should not be derived by presupposing that the position of discrimination is justified. In simple words, the justification for excluding certain services should not be based on an unreasonable provision. A service provider that renders services to foreign recipients would fall within the ambit of export of service, if it was not for section 13(8), as it meets the requisite criteria for it.

HISTORY OF TAXATION OF EXPORT OF INTERMEDIARY SERVICES

In the foregoing paragraphs, the history of export of services with reference to intermediary services has been discussed. The Finance Act, 1994 **("Finance Act")** was the first to impose a service tax, which took effect on July 1, 1994. The relevant service tax provisions were laid out in Chapter V of the FA. Section 64 (1) of the Finance Act stated that Chapter V would apply to all of India except Jammu and Kashmir and according to Section 64(3) service tax applied to taxable services on or after the commencement of the Act. Section 93(1) of the Finance Act empowered the central government to exempt a taxable service of any specified description from all or part of the service tax levied on it, either generally or subject to conditions. Section 93(2) allowed the central government to issue a special-order to exempt individuals from paying service tax in exceptional circumstances.

Pursuant to the same, the central government issued the Export of Services Rules 2005 **("ESR")** under sections 93 and 94(2)(f) of the Finance Act. As per rule 4 of ESR, any service that is taxable under section 65 of the Act, clause (105), may be exported without paying service tax. As per rule 3(2) of the ESR, the following are the conditions for any taxable service specified in Rule 3(1) to be treated as export of service, namely:

(a) such a service must be provided and used outside of India; and

[14] *Material Recycling Association of India v Union of India and Ors* (2020) 79 GSTR 232

(b) the service provider must receive payment in convertible foreign exchange for such services provided outside of India.

Out of these two conditions, the first condition was omitted after subsequent amendments in 2007 and 2010. Prior to 1 July 2012, the position with regards to the export of taxable service was that even if a portion of the service was performed outside India and the rest was performed in India, it would still be treated as having been performed outside India and thus be construed as an export of service. And all taxable services, if exported, were exempt from taxation. This position continued until July 1, 2012.

The Finance Act of 2012 made significant changes to Chapter V of the Finance Act, which took effect on July 1, 2012. The term 'taxable service' was defined in Section 65B (51) of the Finance Act to mean any service that is subject to service tax under the charging provision i.e., Section 66B. The resultant effect was that service tax was only levied on services provided or agreed to be provided in the 'taxable territory,' i.e., the entire country of India, excluding Jammu and Kashmir.[15] In terms of section 66B, to be a taxable service, a service must be:

- Provided by a person to another
- In the taxable territory
- And must not form part of the negative list under section 66D.

As a result, services specified in the negative list and the service rendered outside of India's taxable territory were not considered a 'taxable service' under the FA.

Subsequently, the Place of Provision of Services Rules, 2012 **("PoPS")** were brought, through a notification[16] in terms of section 66C, to replace two operating rules of that time regarding cross-border transactions, *namely*: Export of Services, Rules, 2005 and the Taxation of Services (Provided from Outside India and Received in India) Rules, 2006. PoPS outlined how to determine

[15] The Finance Act 2012, combined reading of § 66B, § 64(1), and § 65B (52).

[16] 'Notification No. 28/2012' (*Central Board of Indirect Taxes and Customs*, 20 June 2012)

<https://www.cbic.gov.in/resources//htdocs-servicetax/strules-place-of-provsn.pdf;jsessionid=49590A61A53ED791B4F07A0A09B3D4FE> accessed 20 October 2021

a taxing jurisdiction for services, since identifying the same in case of import and export of services was difficult at that time. The rationale behind this was to harmonize rules for determining the place of service with international practices to avoid double taxation or non-taxation.[17]

It was common to tax services provided by businesses to other businesses based on the location of their customers, as well as services provided by businesses to consumers based on the location of the service provider. An amendment was brought in Service Tax Rules, 1994, which inserted rule 6A, defining "export of services". The same is reproduced below:[18]

> *"**(1) The provision of any service provided or agreed to be provided shall be treated as export of service when**, -*
>
> *(a) the provider of service is located in the taxable territory,*
>
> *(b) the recipient of service is located outside India,*
>
> *(c) the service is not a service specified in the section 66D of the Act,*
>
> ***(d) the place of provision of the service is outside India,***
>
> *(e) the payment for such service has been received by the provider of service in convertible foreign exchange, and*
>
> *(f) the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 2 of clause (44) of section 65B of the Act."*

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[17] 'Taxation of Services: An Education Guide' (*Central Board of Indirect Taxes and Customs*, 20 June 2012) Pg 51 <https://www.cbic.gov.in/resources//htdocs-servicetax/EducationGuide.pdf;jsessionid=FA9A99938B2A6FE98E20B1079D130402> accessed 20 October 2021

[18] 'Notification No. 36/2012-ST' (*Central Board of Indirect Taxes and Customs*, 20 June 2012) <https://www.cbic.gov.in/htdocs-servicetax/st-notifications/st-notifications-2012/st36-2012>

To determine place of provisions of service under sub-clause (d) of clause (1) of Rule 6A of PoPS rules had to be referred. Rule 3 provided place of provision generally to be location of recipient,[19] and Rule 9 provided place of provision of specified services to be location of service provider.[20] Both of the rules are reproduced below:

> *"3. The place of provision of a service shall be the location of the recipient of service.*
>
> *. . .*
>
> *9. The place of provision of following services shall be the location of the service provider: —*
>
> *(a) Services provided by a banking company, or a financial institution, or a nonbanking*
> *(b) financial company, to account holders;*
> *(c) Online information and database access or retrieval services;*
> ***(d) Intermediary services;***
> *(e) Service consisting of hiring of all means of transport other than, —*
> *i. Aircrafts, and*
> *ii. Vessels except yachts, up to a period of one month"*

Intermediary services fell within the operation of Rule 9, due to which the place of provision for these services was the location of the service provider. Central Board of Indirect taxes and Customs issued a guidance note which provided the scope of intermediary services to be a person who arranges or facilitates a supply of goods, a provision of service, or both, between two people without any material alteration or additional processing.[21] The guidance note further provided that,

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[19] Place of Provision of Services Rules 2012, Rule 3.

[20] Place of Provision of Services Rules 2012, Rule 9.

[21] 'Taxation of Services: An Education Guide' (*Central Board of Indirect Taxes and Customs*, 20 June 2012) Pg 67 <https://www.cbic.gov.in/resources//htdocs-servicetax/EducationGuide.pdf;jsessionid=FA9A99938B2A6FE98E20B1079D130402> accessed 20 October 2021

at any given time, an intermediary is involved in two supplies: the supply between the principal and the third party; and the supply of his own service (agency service) to his principal, for which a fee or commission is typically charged. An intermediary in the sale of goods (such as a commission agent, a buying or selling agent, or a stockbroker) was by definition excluded from this rule. A person who arranges or facilitates the provision of a service (referred to in the rules as "the main service") but performs the main service on his own account was also exempted from this sub-rule.

The following factors were enumerated to determine whether a person is an intermediary, *namely*:[22]

- Nature and value: Although the principal may authorise the intermediary to negotiate a different price, an intermediary cannot change the nature or value of the service he facilitates on behalf of his principal. Furthermore, the principal must be aware of the exact price at which the service is provided (or obtained) on his behalf, and any discounts obtained by the intermediary must be passed on to the principal.
- Separation of value: The value of an intermediary's service must be distinguishable from the main supply of service that he is coordinating. It can be based on a percentage of the sale or purchase price that has been agreed upon. The amount charged by an agent to his principal is referred to as "commission" in most cases.
- Identity and title: Intermediary services provided on behalf of the principal are clearly identifiable from the main supply.

An amendment was brought to PoPS wherein the definition of intermediary was changed with effect from October, 2014, to include a broker or an agent with respect to supply goods.[23] Earlier, if an intermediary was engaged in supply of goods, the location of service was location of recipient, qualifying such supply as export of service when provided to a foreign recipient. The amended definition given in Rule 2 is reproduced below:

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[22] Ibid.

[23] 'Notification No. 14/2014 - Service Tax'(*Ministry of Finance (Department of Revenue)*, 11 July 2014)

<https://www.indiabudget.gov.in/budget2014-2015/ub2014-15/cen/142014ST.pdf>

> *"(f) "intermediary" means a broker, an agent, or any other person, by whatever name called, who arranges or facilitates a provision of a service (hereinafter called the 'main' service) or a supply of goods, between two or more persons, but does not include a person who provides the main service or supplies the goods on his account"*[24]

Additionally, through an amendment, online information and database access or retrieval **("OIDAR")** services were excluded from Rule 9 of PoPS with effect from December, 2016.[25] OIDAR services are primarily delivered over the internet or an electronic network that relies on the internet or a similar network for delivery. Another important feature of these services is that they are fully automated and require very little human intervention. The effect of this amendment was that in case of supply of OIDAR services, the location of provision of services changed from location of supplier to location of recipient. It qualified supply of these services as export of services when provided to a foreign recipient. Thus, the position prior to this amendment was reversed, export of OIDAR services was exempted instead of their import.[26] This amendment was brought to provide a level playing field to suppliers of OIDAR services located in India and tax their import.[27]

Representations were made to on similar provisions for intermediary services as well, to exclude them from Rule 9 and bring the position at par with global best practice.[28] However, the position after this amendment was continued in the GST regime as well. Section 13(8) is analogous to Rule

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[24] Place of Provision of Services Rules 2012, Rule 2.

[25] 'Notification No 46/2016-Service Tax' (*Central Board of Indirect Taxes and Customs*, 09 November 2016) <https://www.cbic.gov.in/resources//htdocs-servicetax/st-notifications/st-notifications-2016/st46-2016.pdf;jsessionid=C521FE5D0EFB96805E52B6AAE0082A4B>

[26] 'Press Release' (*Central Board of Indirect Taxes and Customs*) <https://www.cbic.gov.in/resources//htdocs-cbec/press-release/cbec-press-release-11-11-16.pdf;jsessionid=66848EBF7E5B4322B44DB434906A1910> accessed 20 October 2021

[27] Ibid.

[28] 'Pre-budget Memorandum 2017' (*The Institute of Chartered Accountants of India*) Pg 38 <https://idtc-icai.s3.amazonaws.com/download/preBudget-Memorandum-2017-IndTaxes.pdf> accessed 20 October 2021

9 of the PoPS. Numerous representations have been made in the GST regime to give relief to suppliers of intermediary services so that they could efficiently participate in international trade. With this background, the next portion examines the IGST Act on the bedrock of all statutes – Article 14.

IGST ACT VIS-À-VIS ARTICLE 14

When it comes to an economic or financial legislation, the state is the vested with utmost flexibility. However, such laws must not be in violation of Article 14 of the Constitution, i.e., it must not violate the people's right to equality, and if it does, it will be declared void up to the degree of such repugnancy under Article 13(2) of the Indian Constitution.[29] As a result, every law must satisfy the constitutionality test, which is nothing more than a sparkly term for the rationality test. It is a general understanding that anytime fiscal legislation is enacted with the aim of levying taxes on a certain product or exempting some other product from taxation, the creation of a classification is essential.[30]

The Supreme Court in the case of *East India Tobacco Co* v. *State of Andhra Pradesh*[31] held that it is incumbent on the person who challenges a law as discriminatory to prove that it is not based on a valid classification, and this burden is amplified when the law being challenged is a taxing statute. While the state has broad discretion in deciding which people or things to tax, and the statute would not be open to challenge merely because it taxes some people or things but not others, the statute must pass the constitutional test of Article 14. For a classification to be valid, it must not create a class of person or things to put them in a disadvantageous position than others. Article 14 states that all people who are subjected to legislation should be treated equally in the same circumstances and under the same conditions.

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[29] *Kerala Hotel and Restaurant Association and Ors v State of Kerala and Ors* (1990) 2 SCC 502

[30] Ibid.

[31] *East India Tobacco Co v State of Andhra Pradesh* (1962) AIR 1733

To pass the test of reasonable classification, a legislation must not be arbitrary. To prove reasonability of a legislation, two conditions must be met:[32]

(i) the classification done in the legislation must be based on an intelligible differentia that distinguishes those who are grouped together from those who are not, and

(ii) the differentia must have a rational relationship to the object that the statute is attempting to achieve. While classification can be based on a variety of factors, there must be a link between the basis of classification and the purpose of the Act under consideration.

The IGST Act discriminates certain services provided under section 13(8) of IGST Act from other services. The same is reproduced below:

> *"13(8) The place of supply of the following services shall be the location of the supplier of services, namely: –*
>
> *(a) services supplied by a banking company, or a financial institution, or a non-banking financial company, to account holders;*
>
> *(b) intermediary services;*
>
> *(c) services consisting of hiring of means of transport, including yachts but excluding aircrafts and vessels, up to a period of one month."*[33]

Intelligible Differentia

In the above-mentioned provision, apart from intermediary services, banking services and transport services are also kept out of the purview of export of services by designating location of services as location of supplier. The group of classes created therein is not based on an intelligible differentia because there is no reason provided to designate the location of these services in a manner different from the rest of the services. The absence of reason was first noted during the service tax regime and continued in the GST regime.

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[32] *Motor General Traders v State of Andhra Pradesh* (1984) 1 SCC 222

[33] The Integrated Goods and Services Tax Act 2017, § 13(8).

The mechanism to tax intermediary services provided to foreign enterprises is arbitrary, with reference to other similar services provided to foreign enterprises. The rationale behind taxing an intermediary for providing services to foreign enterprises is not specifically stated by the government, and the same was not a part of discussion in the parliamentary speeches or debates. There are several exemptions available for exports with the aim of increasing foreign reserves, however, no such exemption has been granted to the intermediary suppliers.

Relation of differentia with the object of the Act

For a classification to pass the test of Article 14, it must not be arbitrary but has to be rational, it means that the classification must be based on some qualities or characteristics that are shared by all those grouped together, but not by those who are excluded, and those qualities or characteristics must have a reasonable relationship to the legislative object.[34] In the present case there are no shared objective qualities provided by the government which the banking services, intermediary service and transport service share that distinguish them from the rest of the services.

Furthermore, the statement of objects and reasons accompanied by one hundred and twenty second bill carves out the scope of entire IGST Act, which is to levy GST on inter-state transactions.[35] The preamble to the IGST Act is given below:

> *"An Act to make a provision for levy and collection of tax on inter-State supply of goods or services or both by the Central Government and for matters connected therewith or incidental thereto."*[36]

It is clear that the legislation was enacted to tax inter-state supply of goods and services. The classification of the specified services under section 13(8) artificially creates an opportunity to tax the export of those services. Even if the same is permissible, it is not related to the object of the

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[34] *R K Garg v Union of India* (1981) 4 SCC 675

[35] 'The Constitution (One Hundred and Twenty-seventh Amendment) bill, 2014' (*Central Board of Indirect Taxes and Customs*) <https://www.cbic.gov.in/resources//htdocs-cbec/gst/consti-amend-bill-122-2014-new.pdf;jsessionid=466BDBD15560E9FD065FF7CE99716184> accessed 20 October 2021

[36] The Integrated Goods and Services Tax Act 2017, Preamble.

act in any way. The rationale for treating export of intermediary services differently from export of other services has not been specified by the Parliament. It has been merely stated that the concept of 'intermediary' was borrowed from the Service Tax Regime into the GST, but no reasoning for such a contrasting treatment of intermediary has been given. Thus, differentia created is not intelligible and must be viewed as arbitrary.

CLASS DISCRIMINATION WITHIN INTERMEDIARY SERVICES

Article 14 clearly prohibits class legislation, but it does not prohibit reasonable classification. The implication is that the classification must be reasonable i.e., the differentia, that separates those who are grouped together from those who are not, must have relationship with the object of the legislation.[37] To pass the Article 14 criteria of reasonable classification, the classification must not be "arbitrary, artificial, or evasive," but must be founded on some actual and substantial distinction that has a just and reasonable relationship to the legislative intent and object.[38]

The aim of this part is to highlight unequal treatment of services under the IGST Act within the class of intermediary services, otherwise known as class discrimination, which is prohibited by virtue of Article 14. There is differential treatment in violation Article 14 of the Constitution because some intermediary services have been kept beyond the operation of section 13(8) and thereby do not invoke 8(2) and classify as export of services. This framework creates a discriminatory advantage for some service providers who export their services, such as suppliers of research and development in the pharmaceuticals sector[39], Marketing agents,[40] management

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[37] *Anant Mills Co Ltd v State of Gujarat & Ors* (1975) 2 SCC 175

[38] *R K Garg v Union of India* (1981) 4 SCC 675

[39] Ministry of Finance, Notification No. 04/2019- I.T. (*Central Board of Indirect Taxes and Customs*, 20 June 2012) (Issued on September 30, 2019) <https://www.cbic.gov.in/resources//htdocs-cbec/gst/notfctn-4-2019-igst-english.pdf;jsessionid=6090858CC7B0271C6998FB3109985FA5> accessed 20 October 2021

[40] 'Notification No. 53/98-S.T. 70' (*Central Board of Indirect Taxes and Customs*, 16 October 1998) <https://www.cbic.gov.in/resources//htdocs-servicetax/st-profiles/mkt-research.pdf;jsessionid=736E3CEFCDD276A4ED7C33CB66A931D2> accessed 20 October 2021

consultants and advisors,[41] from other service providers. This discriminatory advantage has been provided without proper reasoning and does not have a reasonable relationship with the object of the IGST Act.

Supply of these services is also intermediary because they are involved with two supplies simultaneously, one between principal and third party, and the other between himself and the principal, for which a fee or commission is charged.[42] However, they are exempted from the tax net when they are exported to a foreign recipient. This creates a dichotomy because although taxing some intermediary services are provided, taxing other services are prohibited and this class discrimination that does not align with the object of the Act is in violation of Article 14 of the Constitution.[43]

It is imperative to refer to the 139th Parliamentary Committee Report with regard to place of supply of services wherein it was recommended to rectify this error, but the same was not given effect to. The Parliamentary Committee Report precisely pointed out that the mechanism to charge taxation on intermediary services is erroneous. It was further stated in the report that the Government needs to use the power given under Section 6(1) to exempt the intermediary services provided to a foreign enterprise from tax and consider them as export of services.

PART III: EXTRA-TERRITORIAL OPERATION

The relevant constitutional provision to analyze the extra-territoriality aspect is Article 245, which is reproduced below:

> *"245. Extent of laws made by Parliament and by the Legislatures of States. —*

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[41] 'Notification No. 53/98-S.T. 66' (*Central Board of Indirect Taxes and Customs*, 16 October 1998) <https://www.cbic.gov.in/resources//htdocs-servicetax/st-profiles/mgmt-busconsultnt.pdf> accessed 20 October 2021

[42] 'Taxation of Services: An Education Guide' (*Central Board of Indirect Taxes and Customs*, 20 June 2012) <https://www.cbic.gov.in/resources//htdocs-servicetax/EducationGuide.pdf;jsessionid=FA9A99938B2A6FE98E20B1079D130402> accessed 20 October 2021

[43] *R K Garg v Union of India* (1981) 4 SCC 675

(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation."[44]

Due to the phrase "Subject to provisions of this Constitution" in Article 245(1), the legislative powers of the Parliament are limited in two ways: i) legislative competence; and (ii) law must be subject to provisions of the Constitution and not hinder the rights conferred by Part III.[45] Clause (2) *prima facie* seems restrictive in its approach to state that Parliament has no bounds when it comes to legislating extra-territorial laws. However, the Supreme Court has construed the scope of sub-clause (2) in the case of *GVK Industries Limited* v. *ITO,*[46] wherein it has been ruled that a law cannot have extra-territorial operation unless the taxing event has some reasonable nexus with India.[47] The IGST Act levies intrastate tax on export of services and this extra-territorial operation is prohibited in India unless there is some reasonable nexus of export of the intermediary services with India. The element of *reasonable nexus* is the deciding factor in establishing validity of the taxing statute.

Sub-clause (8) of section 13 contains three classes of services: banking services, intermediary services and transport services. It is proposed that intermediary services are different from the other two services enumerated. This is because when intermediary services are rendered to foreign recipients, there is no reasonable nexus with India. Thus, while the other two kinds of service may have a reasonable nexus, keeping intermediary services in the same pool leads to unjustified extra-territorial operation.

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[44] The Constitution of India 1950, Article 245.

[45] *A K Gopalan v State of Madras* 1950 SCR 88

[46] *GVK Industries Limited v ITO* (2013) 7 SCC 426

[47] *Sondur Gopal v Sondur Rajini* AIR 2013 SC 2678; *K K Kochuni v State of Madras* AIR 1960 SC 1080

To understand this preposition better, banking services (or services of financial institutions or services of non-banking financial institutions), are rendered to its account holders. Thus, even if the recipient is located outside India, a nexus is created with India by virtue of recipient's choice of opening an account in India. A bank is different from a private transaction because it is regulated by Reserve Bank of India and has direct relationship with the stability in the economy. Whenever banks render services to account holders, bank charges service fee irrespective of their resident status. It is the Indian bank which derives benefit from operation of account by non-resident. Thus, the act of opening an account in an Indian bank creates the requisite reasonable nexus.

With respect to transport services, it must be kept in mind that these services are associated with some movable property only. The idea of transporting a service is inconceivable. Goods that are transported within India on behalf of foreign recipients will have to be physically present within the taxable territory to constitute a reasonable nexus. Although transport services may be rendered to a foreign recipient, they are consumed or utilized within India. So, when transport services are included in this list, they are meant to be taxed by virtue of the nature of their consumption.

Regarding intermediary services, there is no reasonable nexus with India because services are not rendered physically in India and the benefit is accrued to foreign recipients only. For instance, in a case where advertising services are provided to a foreign recipient, the services are received outside India because the benefit is accrued to the foreign recipient. It is immaterial that such services are rendered with respect to the Indian consumer base because the reasonable nexus must be associated with the location where the services are consumed. If the Indian framework permitted origin-based tax, these services might have had a reasonable nexus with India as the services are originating from here, but this is not the case. The flow of supply chain is of vital importance here because it determines from where services begin and where they terminate.

It is crucial to point out that intermediary services which are exported to foreign recipient with respect to consumer base located outside India are treated as export of services.[48] However, in cases where services are rendered with respect to the consumer base in India, the treatment changes

[48] 'Notification No. 20 /2019- Integrated Tax (Rate)' (*Central Board of Indirect Taxes and Customs*, 30 September 2019)

<https://cbic-gst.gov.in/pdf/integrated-tax-rate/notfctn-20-2019-igst-rate-english.pdf> accessed 20 October 2021

and supply ceases to be an export of services, triggering the deeming fiction. To simplify, let's assume an Indian supplier exports services to an American recipient. This is the first supply. From here on a subsequent supply takes place having two possibilities of supply chain: The American recipient of services can direct his supply to customers located either in India or outside India. When the subsequent supply is made to customers located outside India, the first supply is treated as export of services. In contrast, when the American supplier directs his supply to customers located in India, the first supply is treated as an intrastate supply.

This change in treatment is unwarranted because the location of the customers is immaterial. The beneficiary of supply of services is the foreign recipient and not the Indian customers. It is not the case for continuous supply of services because there is a break in the supply chain when these services are exported to the foreign recipient. The intermediary services when rendered to a recipient located outside India come to an end then and there. The subsequent supply from thereon begins with the supply of goods from the foreign supplier and ends with the Indian customer receiving those goods in India. Thus, this discrepancy with respect to location of the consumer base should be resolved and supply of intermediary services to the foreign recipient should be regarded as export of services, irrespective of where the goods or services of main supply are received.

PART IV: CONSTRUING THE BEST PRACTICES

The scheme of the IGST Act is to tax supply in the course of inter-state trade and imports. Exports are excluded from the purview of the GST scheme to encourage Indian suppliers to participate in international trade. The statement of Objects and Reasons accompanying the GST bill emphasized that through this framework, there would be seamless transfer of input tax credit from one stage to another in the supply chain.[49] Export of services are charged on a reverse charge mechanism and considered zero-rated supply, meaning that although it is incumbent upon the supplier of services to pay GST, the government refunds the amount paid by such supplier.[50] In addition, the supplier can claim input tax credit even if the supply is exempted.

[49] *Union of India v VKC Footsteps India Pvt Ltd* 2021 SC OnLine 706

[50] The Integrated Goods and Services Tax Act 2017, § 16.

This is done to ensure that goods produced in India for export are not disadvantaged by domestic tax burden and remain competitive internationally.[51] This is a form of incentive provided to the supplier of services to engage in exports and, in the long run, this mechanism invites persons from other jurisdictions to participate in business with India which in turn results in an increase in exports. However, in cases where a supplier provides intermediary services to a foreign recipient, the supplier cannot claim input tax credit on the taxes paid because these services are not treated as export of services, regardless that both of these services are of the same nature. The intermediary service providers struggle financially because they are deprived of the crucial benefits which are generally available to exports' suppliers.

TREATMENT OF EXPORT OF SERVICES GLOBALLY

The prevalent scheme of GST worldwide (or otherwise known as 'VAT' in some jurisdictions) is identical.[52] In the European Union, VAT liability is exempted in the case of exports of goods or services.[53] Moreover, supply of intermediary services is specifically excluded from the purview of VAT liability.[54] Similarly, in the United States, VAT liability is imposed based on where the services are rendered or the benefit is accrued, meaning that exported services are not subject to sales tax.[55] Imports are taxed because the goods are consumed within the taxable territory, but

[51] 'Tax Exemptions to Indian Exporters' (Press Information Bureau, 20 November 2019) <https://pib.gov.in/Pressreleaseshare.aspx?PRID=1592380> accessed 20 October 2021

[52] 'Exports' (*Revenue Irish Tax and Customs*) <https://www.revenue.ie/en/vat/goods-and-services-to-and-from-abroad/vat-and-exports/index.aspx> accessed 20 October 2021

[53] 'Council Directive 2006/112/EC on the common system of value added tax' (*Official Journal of the European Union*, 11 December 2006) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0112&from=EN> accessed 20 October 2021

[54] Ibid, Article 153.

[55] 'United States - Indirect Tax Guide' (*KMPG*) <https://home.kpmg/xx/en/home/insights/2018/10/united-states-indirect-tax-guide.html> accessed 20 October 2021

exports are tax-free. The rationale for referring to global practice is to highlight that supply going outside taxable territory is not taxed because the importing country will levy tax on such supply.

In the present Indian GST framework, if a supplier exports his intermediary services to non-resident recipients, the services will be liable for GST in the importing country as well in India. The policy of Indian government has been to avoid double-taxation. Levying domestic tax on cross-border supply, which will not go untaxed otherwise, will be against the public policy of India. This mechanism levies unwarranted tax that leads to double-taxation. Hence, even though a service falls within the category of intermediary services, it should be considered as export because the supply is still export of intermediary services and as per the long-standing policy of Government of India, it is prudent for the government to not tax export duty on such supply.

SCOPE OF INTERMEDIARY SERVICES

The Central Board of Indirect Taxes and Customs ("**the department"**) issued a circular in July 2019 to try and clarify the scope of intermediary services, regarding IT Enabled Services providers by providing its different models and categorizing when they will be considered intermediary services.[56] This was subsequently withdrawn *ab initio* by the department after receiving numerous representations expressing concerns about the circular's implications. Thereafter, the department recently issued a clarificatory notification on the scope of intermediary services.[57] *Sine qua non* for an intermediary service as per that notification is given below:

- Minimum of three parties: An intermediary is a person who arranges or facilitates the supply of goods, services, or securities between two or more people. As a result, the arrangement necessitates a minimum of three parties, two of whom transact in the supply of goods, services, or securities (the main supply), and one who arranges or facilitates the said main supply (the ancillary supply). As a result, an activity involving only two parties cannot be classified as an intermediary service. An intermediary is a person who "arranges or facilitates" another supply

[56] 'Circular 107/26/2019-GST' (*Central Board of Indirect Taxes and Customs*, 20 18 July 2019) (Issued on July 18, 2019).

<https://cbic-gst.gov.in/pdf/circular-cgst-107.pdf> accessed 20 October 2021

[57] 'Circular No. 159/15/2021-GST' (*Central Board of Indirect Taxes and Customs*, 20 September 2021)

<https://www.cbic.gov.in/resources//htdocs-cbec/gst/Circular%20No.%20159_14_2021_GST.pdf> accessed 20 October 2021

(the "main supply") between two or more other people, but does not provide the main supply himself.

- Two distinct supplies: There must be two supplies, namely: Main supply between two principals, and ancillary supply, which is the service of facilitating supply between two principals. The latter must be clearly identifiable and will be considered intermediary services.

In the notification there are certain exclusions provided to these requirements as well. For a person to not be included in the ambit of intermediary services, he:

- must not be engaged in supply of goods or services or both or securities on his own account
- must not be a sub-contractor engaged in the main supply.

Thus, the legislature intended that a third party who is supplying certain services to the foreign recipient on a principal-to-principal basis will not be considered to provide intermediary services.[58] The notification mentions certain illustrations where supply of certain services will not be considered intermediary services, such as outsourcing of the main supply. On the other hand, services of arranging outsourcing of supply or identifying client base (brokering) for the main supply will be considered intermediary services.

The definition of intermediary services provided in the IGST Act states that:

> *"Intermediary means a broker, an agent or any other person, by whatever name called, who arranges or facilitates the supply of goods or services or both, or securities between two or more person…"*[59]

The phrase "any other person by whatever name called" is somewhat problematic because it widens the scope of intermediary services to cover every business that performs a supporting role which may or may not have a reasonable nexus with India. The circular provides that the definition is not inclusive and that an intermediary service provider must have the character of either an agent or a broker to fall within the ambit of this definition. However, the general practice so far has not

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[58] *GoDaddy India Web Services Pvt Ltd v Commissioner of Service Tax* (2016) 54 GST 681

[59] 'Circular No 159/15/2021-GST' (*Central Board of Indirect Taxes and Customs*, 20 September 2021)

<https://www.cbic.gov.in/resources//htdocs-cbec/gst/Circular%20No.%20159_14_2021_GST.pdf> accessed 20 October 2021

been in consonance with this practice because all businesses engaged in export of services that are supporting roles are made liable to pay taxes in India.

By definition, the intention of the legislature is not to tax all suppliers of services who facilitate main supply. The objective is to tax those suppliers who are acting as agents or brokers. Thus, there must be some definitive tests or factors that should be taken into consideration while determining which supplies will qualify as intermediary services. Such factors may include:

I. Whether the main supplier exercises a degree of control over the activity of an ancillary supplier: A supplier of ancillary services will be considered to be an agent if he carries on business of the main supplier in India. It is a natural corollary that the main supplier exercises control over the operations of ancillary suppliers, similar to a principal-agent relationship. There is a certain degree of exclusivity involved therein. For instance, if A, a foreign supplier of services engages B, an Indian service provider for rendering services exclusively to A, B will be considered as supplier of intermediary service and the supply must not be considered as export of services.

II. Whether ancillary supplier renders services in India on behalf of main supplier: For this, the actual amount of work undertaken by the agent as compared to the main supplier will be irrelevant. For instance, if A, a foreign supplier of main services engages B, an Indian service provider, for only identifying specific client base on behalf of A and then concludes the contract with the client itself, then B will be considered to provide intermediary service. On the contrary, if A engages B for advertising A's product in India generally, as a result of which, a client base is constituted which directly initiates contract with A, B is not providing intermediary services.

III. Nature of ancillary services provided: If the nature of service is such that the ancillary service provider who was engaged in the beginning of supply continues to have prolonged engagement with the consumer beyond the initial supply as part of the agent services provided to the foreign recipient, the service provider will be considered intermediary service provider. For instance, if A, a foreign supplier of machinery or equipment, engages B, Indian service provider, to advertise product of A in India and to communicate documentary requirements to the client and after verification, forward the said verified documents to A. Additionally, B is also entrusted to install the machinery or equipment in

client's premises after finalizing the contract and to handle customer care services as well. Here, after the initial supporting role, B is providing services to A until the contract is agreed upon, and even after such agreement, continues to provide his services to A. B will be considered a supplier of intermediary services.

The circular provides clarity to some extent, but at the same time, there is still room for ambiguity in the interpretation of intermediary services. It is incumbent upon the courts to implement the statute but the ambiguity leaves space for judicial discretion. And when it comes to taxing statutes, judicial discretion is bound to favour the statute to a great extent to uphold the present framework. It is necessary for the legislature to remove the unreasonableness to ensure efficient mechanism of levying the tax. It is imperative that certain definitive guidelines are formulated for this provision so that some clarity is provided to the courts as well as to the suppliers.

PART V: CONCLUDING REMARKS

CLASSIFICATION OF SUPPLY – SECTION 8(2) OR SECTION 7(5)?

In accordance with Section 13(8)(b), it is specifically stated that the place of supply of services provided by an intermediary to an overseas customer is to be taken as the location of the supplier of services, which is the location of that intermediary. This is where section 8(2) is invoked to create the controversial deeming fiction. This portion analyzes whether the supply could be classified under section 7(5)(c) instead of section 8(2). Relevant provisions are reproduced below:

"7. Inter-State supply

(5) Supply of goods or services or both, —

(a) when the supplier is located in India and the place of supply is outside India;

(b) to or by a Special Economic Zone developer or a Special Economic Zone unit; or

(c) in the taxable territory, not being an intra-State supply and not covered elsewhere in this section,

shall be treated to be a supply of goods or services or both in the course of inter-State trade or commerce

. . .

8. Intra-State supply

(2) Subject to the provisions of section 12, supply of services where the location of the supplier and the place of supply of services are in the same State or same Union territory shall be treated as intra-State supply:

Provided that the intra-State supply of services shall not include supply of services to or by a Special Economic Zone developer or a Special Economic Zone unit."

On the one hand, section 8(2) states that in cases where the location of supplier and the place of supply are in the same state then such a supply would be treated as intrastate supply. On the other hand, section 7(5)(c) of the IGST Act covers all other supplies within India. Section 8(2) of the IGST Act becomes applicable for transactions through Section 13(8)(b), which covers the gamut of supply within a state by intermediary and it specifically designates the location of supplier as the place of supply of such services.

The intermediary services rendered by an Indian service provider to a foreign recipient would be ascertained as intra-state supply, as the place of supply of service is location of supplier. Seemingly, it can be argued that such a transaction shall be classifiable under Section 7(5)(c) as it has a wide ambit covering all kinds of supply of services except intra-State supply. Section 13(8)(b) explicitly states that the place of supply for intermediary services shall be the location of the supplier of services and that by virtue of such allocation, the place of supply and location of services will always be the same. Thus, the supply will be treated as intra-state supply. This framework leaves no confusion for the application of Section 8(2).

CONSTITUTIONAL, LEGAL AND COMMERCIAL VIABILITY OF THE PRESENT FRAMEWORK

The current framework creates class discrimination without a rationale nexus and thus, creates an arbitrary taxing mechanism for intermediary services. The adoption of mechanisms of service tax regime without molding them as per the current principles on which GST is based has led to the controversy of this paper. The argument on which the government pleaders have relentlessly relied upon is the 2014 PoPS rules that permitted taxing the export of intermediary services. However, that framework was different and the country underwent major tax reform in 2017 when GST was

introduced. The previous service tax regime had flaws that hampered the efficient application of taxation that caused unnecessary hardships to taxpayers. GST was brought in to tackle those challenges and thus, the rationale of the previous regime cannot be carried forward to this regime *as it is*. Due to this borrowing, the unnecessary controversy with respect to intermediary services has also been carried forward in the GST regime as well.

The overall scheme leads to a consequence which is commercially not viable for exporters of intermediary services. Once services are rendered, those services are taxed in two jurisdictions, in India as well as the jurisdiction where services are exported. Additionally, intermediary services are not big conglomerates with huge profit margins. They are small and medium enterprises who earn a small commission by giving their services abroad. If they continue to pay 18% GST on those earnings, their operation no longer remains financially viable. This discourages intermediary service providers from engaging in international trade and may drive some enterprises to terminate functioning in domestic markets as well.

In addition, continuing with the present framework will impact India's gross value added as well, 54% of which was contributed by services sector in financial year 2021.[60] According to the RBI, India's service exports stood at US$ 19.72 billion in June 2021, while imports stood at US$ 11.14 billion.[61] During 2000-2021, India attracted a total of US$ 87.06 billion in foreign direct investment (FDI) and the services sector ranked first in terms of FDI inflows. This data highlights that potential of growth in the service sector despite the levy of domestic tax. This sector has the scope to flourish further after this controversy is resolved. The revenue that the government will be foregoing could be easily retrieved if it will make more sense for domestic service providers to engage with foreign recipients. As a result of this engagement, imports will increase as well.

Thus, the ideal solution would be to remove section 13(8)(b) of the IGST Act and prevent designating place of supply as location of the supplier in case of export of intermediary services. This will mean that place of supply will be location of recipient and thus, would be out of the

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[60] 'Services Sector in India' (*India Brand Equity Foundation*, 12 October 2021) <https://www.ibef.org/industry/services.aspx>

accessed 20 October 2021

[61] Ibid.

purview of tax net in India. Alternatively, it is proposed that an amendment could be made to replace intermediary services in 13(8) (b) with "services in nature of an agent or broker" for the sake of clarity.

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