PUNJAB & HARYANA HIGH COURT LAYS DOWN GUIDELINES FOR DENIAL OF ITC UNDER SECTION 16(2)(C) – HOLDS THAT SUPPLIER'S DEFAULT CANNOT MECHANICALLY RESULT IN DENIAL OF ITC TO PURCHASING DEALER

The Punjab and Haryana High Court, in a batch of 424 writ petitions*, has upheld the constitutional validity of Section 16(2)(c) of the CGST Act, 2017, but held that the provision cannot be invoked mechanically to deny Input Tax Credit ("ITC") to a purchasing dealer merely because the selling dealer has failed to deposit tax with the Government or its registration has subsequently been cancelled, including retrospectively. The Court laid down detailed guidelines governing ITC denial, issuance of show cause notices, invocation of Section 74 and cancellation of registration.

Background & Key Facts

The writ petitions concerned denial of ITC to purchasing dealers on account of non-payment of tax by selling dealers, including cases involving subsequent retrospective cancellation of suppliers' GST registrations. The principal issue was whether a

**Shaurya Alloys Pvt. Ltd. v. State of Punjab and Another, CWP-34296-2024 and other connected cases, Punjab and Haryana High Court, judgment dated 1 October 2026.*

purchasing dealer, having paid the tax charged by the supplier but having no means to independently verify its deposit with the Government, could be denied ITC solely on account of the supplier's default. The petitioners also challenged the constitutional validity of Section 16(2)(c) under Articles 14, 19(1)(g), 21, 265 and 300A of the Constitution and, in the alternative, sought that it be read down to cases of fraud, collusion or non-existent suppliers. The Revenue relied on the Gujarat High Court's decision in Maruti Enterprises, affirmed by the Supreme Court in Bhandari Scrap Traders.

Ruling

On the constitutional challenge, the High Court upheld the validity of Section 16(2)(c), read with Section 155, and declined to read it down. It held that the real grievance lay in the manner in which the provision was being invoked, and not in the provision itself.

The High Court, however, held that Section 16(2)(c) must be applied in consonance with the statutory scheme, including Sections 41, 73, 74, 75(12), 76, 79 and 155 and Rule 37A, and cannot be invoked in a routine or mechanical manner. Subsequent cancellation of a supplier's registration, a nil or short tax liability reflected in its returns, or information received by the Department may trigger an inquiry but cannot, by itself, justify denial or reversal of ITC. The Court noted that the matching and reconciliation mechanism originally envisaged under Sections 37 to 42 was never operationalised, and that indiscriminate invocation of Section 16(2)(c) would render Section 76 (tax collected but not paid) meaningless.

The Court observed, in substance, that *"the fraud of the selling dealer does not, by itself, become the fraud of the purchasing*

dealer unless the notice discloses the facts connecting the purchasing dealer with such fraud."

The High Court laid down 14 guidelines, the key aspects of which are summarised below:

1. **Application of mind:** Before issuing a show cause notice, the proper officer must examine, and record its satisfaction on, the supplier's particulars, relevant invoices and tax periods, ITC amount involved, nature of the default and status of recovery proceedings against the supplier under Sections 73, 74, 75(12) read with 79, and 76.

2. **Evidence-based denial:** The investigation must establish a direct link between the purchasing dealer and the alleged default or fraudulent conduct. The supplier's default or cancellation of registration cannot, by itself, establish the purchasing dealer's ineligibility.

3. **Disclosure in show cause notice:** The notice must disclose the material relied upon, supplier details, the manner in which ITC was allegedly wrongly availed and supporting documents. Key material relied upon, such as alerts, inspection reports, statements and e-way bill, toll and banking data, must be supplied to the purchasing dealer, subject to lawful privilege.

4. **Invocation of Section 74 / Section 74A:** Where Section 74 (or the fraud limb of Section 74A) is invoked, the notice must itself set out the foundational facts establishing fraud, wilful misstatement or suppression attributable to the purchasing dealer. Mere reproduction of statutory expressions is insufficient. Deficiencies in the notice cannot be cured subsequently through a counter affidavit.

5. **Burden of proof and genuine transactions:** The burden of establishing ITC eligibility continues to rest on the purchasing dealer under Section 155 and may be discharged through tax invoices, proof of receipt of goods or services, e-way bills, transport receipts, weighbridge slips, stock records and consumption records. The proper officer must consider such evidence and deal with it in the adjudication order.

6. **Retrospective cancellation:** Where ITC denial is based on retrospective cancellation of the supplier's registration, the proper officer must examine the grounds and effective date of cancellation and their bearing on the genuineness of the relevant supply.

7. **Prevention of double recovery:** The Department must verify proceedings against the selling dealer, coordinate with the jurisdictional officer where necessary, and account for tax already recovered or deposited in respect of the same supply. Re-availment must be allowed to the extent permissible under the proviso to Section 41(2) and Rule 37A, subject to Section 17(5)(i).

8. **Applicable statutory framework:** The provisions governing ITC reversal and re-availment applicable during the relevant tax period must be followed. Subsequent amendments or mechanisms cannot be applied retrospectively. In particular, the absence of a reversal and re-availment mechanism prior to the insertion of Rule 37A with effect from 26 December 2022 must be kept in mind.

9. **Procedural safeguards:** A personal hearing under Section 75(4) must be granted. Requests for cross-examination, where third-party statements are relied upon, must be decided by a reasoned order. The adjudication order must

address the taxpayer's reply and record specific findings on each disputed condition under Section 16(2) and, where applicable, fraud, wilful misstatement or suppression.

The Court further held that the registration of a purchasing dealer cannot be cancelled, particularly with retrospective effect, merely because ITC was availed on purchases from a subsequently deregistered supplier, without independent satisfaction of a ground under Section 29(2) and compliance with the prescribed procedure. A deposit made during investigation, including through Form GST DRC-03, also does not dispense with the requirement of a show cause notice disclosing the foundational facts.

The guidelines apply to all pending and future proceedings before the proper officers of the Centre, Punjab, Haryana and Chandigarh. In pending matters, taxpayers may file replies or supplementary replies within eight weeks where proceedings are at the show cause notice stage. Matters in which adjudication orders have already been passed must be reconsidered in light of the guidelines after granting a personal hearing and passing fresh reasoned orders. The impugned orders have not been set aside but will abide by the fresh decision, and the proper officer may issue a supplementary notice or corrigendum with an opportunity to reply. No fresh coercive recovery is to be made in the interim, and amounts already deposited or recovered, including by way of ITC reversal, will be adjusted or refunded with admissible interest depending on the outcome. The petitions have been remitted for fresh consideration, with all pleas on merits left open.

VA Comments

The judgment provides significant relief to genuine purchasing dealers facing ITC demands arising from supplier defaults or retrospective cancellation of GST registrations. It reinforces that the Department must undertake a fact-specific inquiry and cannot presume the purchasing dealer's involvement merely from the supplier's non-compliance. While the guidelines bind proper officers in Punjab, Haryana and Chandigarh, the judgment is likely to carry persuasive value before other High Courts and authorities.

Since the burden under Section 155 continues to rest on the purchasing dealer, businesses should maintain adequate documentary evidence to substantiate ITC claims and examine whether show cause notices disclose the relevant invoices, supporting material and the specific grounds for denial. The judgment also strengthens the requirement to establish foundational facts before invoking Section 74 and requires the Department to prevent double recovery of tax. Taxpayers with pending proceedings in these jurisdictions should evaluate filing replies or supplementary replies within the eight-week window permitted by the Court, and those with adjudication orders already passed should seek a fresh hearing and, where warranted, adjustment or refund of amounts paid.

However, the ruling does not grant blanket protection where transactions are found to be non-genuine, involve collusion or relate to non-existent suppliers or non-receipt of goods or services. The Department also remains free to proceed against defaulting suppliers.

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OUR OFFICES

DELHI

1st, 9th & 11th Floor,
Mohan Dev Building,
13, Tolstoy Marg,
New Delhi - 110001, India,

TEL: +91 11 42492525,
delhi@vaishlaw.com

MUMBAI

106, Peninsula Centre,
Dr. S. S. Rao Road, Parel,
Mumbai - 400012, India,

TEL: +91 22 42134101,
mumbai@vaishlaw.com

BENGALURU

Bhive Premium
Ramanashree (MG Road) No. 2/1,
Brunton Road, Off MG Road
Opposite Old Passport Office
Bengaluru - 560001, India

TEL: +91 80409 03588/ 89
bangalore@vaishlaw.com

VAISH ASSOCIATES ADVOCATES
ESTD. 1971

CORPORATE, TAX AND BUSINESS ADVISORY LAW FIRM