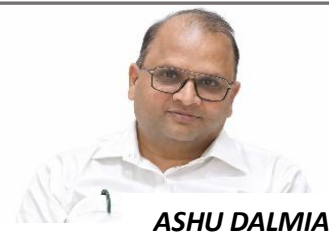


## **Supplier's Sin, Buyer's Penalty** **Decoding Section 16(2)(c) of the CGST Act**



The concept of Input Tax Credit (ITC) lies at the very heart of the Goods and Services Tax regime. Designed to eliminate the cascading effect of taxation, ITC ensures that tax is levied only on value addition at each stage of the supply chain. Under this system, a registered person is entitled to claim credit of taxes paid on inputs and utilize the same against output tax liability. While the framework appears seamless in theory, its practical application has been fraught with disputes, particularly in the context of Section 16(2)(c) of the Central Goods and Services Tax Act, 2017. This provision, which mandates that tax charged on a supply must be “actually paid to the Government,” has become one of the most litigated aspects of GST law.

Section 16(2) of the Central Goods and Services Tax Act, 2017, lays down four cumulative conditions for claiming ITC. Among them, clause (c) has generated the most significant litigation:

***Sec. 16 (2) “No registered person shall be entitled to the credit of any input tax in respect of any supply of goods or services or both to him unless,***

***..***

***..***

***(c) The tax charged in respect of such supply has been actually paid to the Government, either in cash or through utilisation of input tax credit admissible in respect of the said supply.”<sup>1</sup>***

Section 16(2) prescribes the conditions for availing ITC, and clause (c) introduces a significant departure from traditional tax principles by linking the entitlement of the recipient to the compliance behavior of the supplier. In essence, even if the recipient has fulfilled all contractual and statutory obligations, including payment of consideration along with tax to the supplier, the credit may still be denied if the supplier fails to deposit the tax with the Government. This creates a peculiar situation where the purchasing dealer bears the consequences of a default over which it has little or no control. The phrase “**actually paid to the Government**” thus assumes central importance, as it shifts the focus from the transaction between the parties to the ultimate flow of revenue into the public exchequer.

The statutory position is reinforced by **Rule 37A of the CGST Rules, 2017** (inserted vide Notification No. 26/2022-CT dated 26.12.2022). It provides the procedural mechanism for operationalising this condition. The Rule requires the recipient to reverse ITC (along with interest) if the supplier, despite furnishing the invoice details in GSTR-1, fails to file the corresponding GSTR-3B return by 30th September following the end of the financial year in which the ITC was availed. The reversal must be effected in the recipient’s GSTR-

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<sup>1</sup> <https://gstindia.biz/act/1/section/17>

3B on or before 30th November of that year. Upon the supplier's subsequent compliance (filing GSTR-3B and paying tax), the recipient can re-avail the credit.

**Analogous provisions existed in the pre-GST VAT regime, Section 9(2)(g) of the Delhi Value Added Tax Act, 2004, Section 48(5) of the Maharashtra Value Added Tax Act, 2002, and Section 70 of the Karnataka Value Added Tax Act, 2003, all of which emphasised actual payment by the supplier or genuineness of the transaction.**

Judicial responses to these provisions have been varied. On one hand, certain courts adopted a liberal approach, recognizing the inherent limitations faced by purchasing dealers in verifying supplier compliance. On the other hand, a stricter line of reasoning emphasized that ITC is a statutory concession and can be regulated by imposing conditions deemed necessary to protect revenue.

The Delhi High Court took a protective approach towards bona fide purchasers in its early rulings. In ***Shanti Kiran India Pvt Ltd v. Commissioner, Trade and Taxes (Delhi High Court, Division Bench, 04.01.2013)***,<sup>2</sup> the Court observed: *"This Court is of the opinion that in the absence of any mechanism enabling a purchasing dealer to verify if the selling dealer deposited tax, for the period in question, and in the absence of notification in a manner that can be ascertained by men in business that a dealer's registration is cancelled the benefit of input credit, under Section 9(1) cannot be denied."* The Court further noted that cancellations after the transactions and assumptions of collusion based solely on low tax deposits by suppliers were "unworthy of acceptance." **The Supreme Court, in *The Commissioner of Trade and Tax, Delhi v. Shanti Kiran (Supreme Court, Division Bench, 09.10.2025)***, recorded the Delhi High Court's finding that the purchasers were bona fide and entitled to ITC after verification.

Building on this, the Delhi High Court in ***On Quest Merchandising India Pvt Ltd v. Government of NCT of Delhi (Delhi High Court, Division Bench, 26.10.2017)***<sup>3</sup> applied the doctrine of reading down to Section 9(2)(g) of the DVAT Act. In paragraph 62, the Court held: *"the expression 'dealer or class of dealers' occurring in Section 9 (2) (g) of the DVAT Act should be interpreted as not including a purchasing dealer who has bona fide entered into purchase transactions with validly registered selling dealers who have issued tax invoices in accordance with Section 50 of the Act where there is no mismatch of the transactions in Annexures 2A and 2B."* Paragraph 63 clarified that the Department is precluded from denying ITC to such bona fide purchasers and must instead proceed against the defaulting supplier, except where collusion is established under Section 40A. **The Supreme Court declined to interfere in the challenge to this judgment in *Commissioner of Trade and Taxes, Delhi v. Arise India Limited (Supreme Court, 10.01.2018)***.<sup>4</sup>

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<sup>2</sup> <https://gstindia.biz/case-law/230>

<sup>3</sup> <https://gstindia.biz/case-law/228>

<sup>4</sup> <https://gstindia.biz/case-law/221>

The liberal approach found expression in decisions holding that a bona fide purchaser should not be penalized for the supplier's default, particularly in the absence of a mechanism to verify tax payment. These judgments emphasized that once the purchasing dealer has ensured that the supplier is duly registered, obtained valid tax invoices, and made payment through legitimate channels, denial of ITC would result in undue hardship and effectively lead to double taxation. The courts also invoked the doctrine of reading down to interpret statutory provisions in a manner that preserves their constitutionality while protecting genuine transactions. This line of reasoning reflects a broader constitutional concern that fiscal statutes must operate fairly and not impose disproportionate burdens on compliant taxpayers

In contrast, other High Courts adopted a stricter view aligned with the statutory language. **The Bombay High Court in *Mahalaxmi Cotton Ginning Pressing & Oil Industries v. State of Maharashtra* (Bombay High Court, Division Bench, 11.05.2012)** <sup>5</sup> upheld the constitutional validity of Section 48(5) of the MVAT Act, which required actual deposit of tax in the treasury before set-off could be claimed. **The Supreme Court dismissed the Special Leave Petition on 25.02.2013, affirming that ITC is a statutory concession subject to legislative conditions. Under Karnataka VAT, the Supreme Court in *State of Karnataka v. Ecom Gill Coffee Trading Pvt Ltd* (Supreme Court, Division Bench, 13.03.2023)** <sup>6</sup> emphasised the purchaser's burden under Section 70 of the KVAT Act. **The Court held that mere production of invoices and payment to the supplier is insufficient; the purchasing dealer must prove the genuineness of the transaction through cogent material, including details of the vehicle, freight charges, acknowledgement of delivery, and actual physical movement of goods.**

**The Karnataka High Court had earlier taken a more liberal view in *State of Karnataka v. Tallam Apparels*** <sup>7</sup> (Karnataka High Court, Division Bench, 26.02.2021), observing that account payee cheques and other documents demonstrated the transaction was not bogus, and non-remittance by the supplier could not penalise the purchaser. **However, the Supreme Court's decision in *Ecom Gill* clarified that the burden remains squarely on the purchaser to establish genuineness.**

The stricter judicial approach underscores the principle that ITC is not an inherent right but a benefit subject to the fulfillment of statutory conditions. This perspective gained significant momentum with judicial pronouncements emphasizing the burden of proof on the purchasing dealer to establish the genuineness of transactions. Courts adopting this view have held that mere production of invoices or proof of payment is insufficient. Instead, the dealer must demonstrate actual movement of goods, authenticity of the supplier, and overall legitimacy of the transaction. The emphasis on documentary

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<sup>5</sup> <https://gstindia.biz/case-law/226>

<sup>6</sup> <https://gstindia.biz/case-law/222>

<sup>7</sup> <https://gstindia.biz/case-law/233>

evidence, logistical details, and financial trails reflects a heightened scrutiny aimed at curbing fraudulent practices such as fake invoicing and circular trading.

In the GST era, **several High Courts have examined the constitutional validity of Section 16(2)(c) itself. The Gauhati High Court in *National Plasto Moulding v. State of Assam* (Gauhati High Court, Division Bench, 26.06.2024<sup>8</sup>)** held that the issue was squarely covered by the Delhi High Court's *On Quest* judgment and set aside demands for bona fide transactions. The **Tripura High Court, in *Sahil Enterprises v. Union of India* (Tripura High Court, Division Bench, 06.01.2026),** <sup>9</sup>went further and noted that ITC is intended to avoid double taxation and that Parliament did not intend to punish a bona fide purchaser for the supplier's default. Paragraph 47 expressly adopted the Delhi High Court's reading-down approach, stating that Section 16(2)(c) "has to be read down as the Delhi High Court had done." The Court concluded that the petitioner's transaction was bona fide and not collusive, and therefore ITC could not be denied. **The Karnataka High Court followed suit in *Instakart Services Private Limited v. Union of India* (Karnataka High Court, Single Bench, 09.02.2026),<sup>10</sup> disposing of the petition in terms of the Gauhati and Tripura judgments and reading down Section 16(2)(c) and Rule 36(4) to protect bona fide recipients.**

Across these judgments, courts have consistently stressed that the purchasing dealer must demonstrate bona fides to avail the protective interpretations. To establish that the purchaser is a bona fide recipient and that the transaction is genuine, the following categories of documents must be preserved and produced:

- Valid tax invoices bearing the correct GSTIN of the supplier as on the date of supply;
- Proof of payment through banking channels, preferably account payee cheques or electronic transfers, with bank statements and invoice references;
- Evidence of actual receipt and physical movement of goods, including e-way bills, goods receipt notes (GRNs), transporter acknowledgements, vehicle registration details, and freight payment records;
- Contemporaneous stock records, warehouse registers, and internal audit trails showing receipt, storage, and use of the inputs in taxable outward supplies;
- Documentary proof of due diligence, such as screenshots or extracts from the GST portal verifying the supplier's active registration at the time of transaction;
- Reconciliation statements between the purchaser's books, GSTR-2A/2B, and GSTR-3B.

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<sup>8</sup> <https://gstindia.biz/case-law/227>

<sup>9</sup> <https://gstindia.biz/case-law/229>

<sup>10</sup> <https://gstindia.biz/case-law/223>

Recent judicial trends indicate an attempt to strike a balance between these competing considerations. Courts have increasingly recognized that a rigid application of the “actual payment” condition may defeat the very objective of GST by disrupting the seamless flow of credit. At the same time, they have not diluted the responsibility of taxpayers to exercise due diligence. The emerging jurisprudence suggests that while ITC cannot be denied mechanically, the burden on the recipient to establish the genuineness of the transaction remains substantial. This nuanced approach reflects an evolving understanding of the complexities inherent in a multi-stage tax system.

A critical practical limitation must be recognised here. The recipient can verify only what is visible on the GST portal: the supplier’s GSTR-1 declaration (outward supply details), the auto-populated GSTR-2A/2B (ITC statement), and **There is no mechanism for the recipient to trace or confirm whether the tax attributable to his specific invoice has been paid by the supplier to the Government.** The recipient has no access to the supplier’s cash ledger, payment challans, or invoice-wise reconciliation with government receipts. This creates a situation of **legal impossibility** for the recipient to independently ensure compliance with the literal wording of Section 16(2)(c).

In such circumstances, the **doctrine of impossibility** (analogous to Section 56 of the Indian Contract Act, 1872) and the principle of **frustration of contract** come into play. A statutory condition that requires performance beyond the recipient’s control and knowledge cannot be enforced to the recipient’s detriment when he has exercised all reasonable diligence. The recipient who

- (i) verifies the supplier’s active GSTIN on the date of supply,
- (ii) ensures payment through banking channels,
- (iii) reconciles GSTR-2A/2B with books, and
- (iv) maintains complete documentation, cannot be penalised for an event (supplier’s default in depositing tax on that exact invoice) that lies wholly outside his sphere of influence. This position finds strong resonance in the In ***Shanti Kiran India Pvt Ltd v. Commissioner, Trade and Taxes*** line of judgments, where courts have consistently protected bona fide purchasers.

From a practical standpoint, the implications for businesses are significant. The entitlement to ITC is no longer a mere accounting exercise but a function of continuous compliance and risk management. Businesses must adopt robust mechanisms to verify the credentials of suppliers, maintain comprehensive documentation, and ensure alignment between financial records and statutory filings. The importance of reconciling data with auto-generated statements and promptly addressing discrepancies cannot be overstated. In this context, ITC compliance assumes the character of an ongoing obligation rather than a one-time claim.

In conclusion, the evolution from the Delhi VAT *Shanti Kiran* (2013) and *Arise India* (2018) to the GST-era rulings and the Supreme Court’s 2025 affirmation in *Commissioner v. Shanti*

*Kiran India (P) Ltd.* reflects a maturing jurisprudence. While the law rightly insists on an unbroken tax chain to curb fake invoicing, it cannot ignore commercial realities and the doctrine of impossibility. A recipient who follows the *Shanti Kiran* principles, verifying registration, ensuring banking payment, reconciling portal data, and maintaining impeccable records, has fulfilled his statutory and practical obligations. In such cases, Section 16(2)(c) and Rule 37A cannot be invoked to deny ITC merely because the supplier failed to deposit tax on the specific invoice, an impossibility the recipient cannot overcome.

The Delhi High Court's observation (echoed by the Supreme Court) remains the guiding star: **a bona fide purchaser acting in good faith and producing valid invoices after due verification is entitled to ITC.** The department cannot shift the entire risk of supplier default onto the recipient when the law and portal mechanics make exact verification impossible. ITC compliance is therefore not merely an accounting exercise but a continuous due diligence process. **A bona fide purchaser, who has taken reasonable due diligence and can prove the genuineness of the transaction, has a strong case against denial of ITC.** This balanced approach upholds both revenue protection and the fundamental fairness that underpins the GST regime.



*Authored by Ashu Dalmia and places on record his appreciation for the research and drafting assistance provided by Ankita Jha and Anshu Upadhyay.*

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