

CASE ALERT

Case: K-9 Enterprises vs. State of Karnataka [TS-573-HC(KAR)-2024-GST]

The Hon'ble Karnataka High Court in the present case decided on the question of law whether the Electronic Credit Ledger ("ECL") can be blocked by revenue authorities under Rule 86A of the CGST Rules, 2017 ("CGST Rules"), without granting a pre-decisional hearing and without the fulfillment of necessary conditions under the provision. The Hon'ble High Court set aside the earlier judgment of the Learned Single Judge that had upheld the revenue authorities decision to block the ECL, noting several procedural lapses, including the failure to grant a hearing and the improper reliance on findings from another authority without independent inquiry.

The appellant, engaged in the business of lead and lead scrap, had their ECL blocked under Rule 86A of the CGST Rules, on the basis of a field report issued by the investigation wing. This field report alleged that some suppliers were non-existent or not conducting business. Based on this internal report, the adjudication officer mechanically blocked the appellant's ECL without conducting any independent verification or inquiry into the appellant's specific transactions. The Learned Single Judge upheld this blocking of the ECL, leading to the present Writ Appeal.

The Hon'ble High Court set aside the earlier order of the Learned Single Judge on essentially two points as follow:

a) Compliance with principles of natural justice for granting a personal hearing to the taxpayer before blocking of the ITC in ECL

- As per the judgment of the Gujarat High Court in *Samay Alloys India (P) Ltd.*, even though Rule 86A of the CGST Rules does not specifically provide for a pre-decisional hearing, such a requirement must be inferred due to the serious civil consequences involved. A post-decisional hearing would not be sufficient. The High Court emphasized that compliance with the principles of natural justice is a sine qua non, and while Rule 86A does not explicitly provide for or prohibit it, there is a need to read this requirement into the rules.

- The Hon'ble Court pointed out that providing a pre-decisional hearing would not have resulted in immediate or instantaneous utilization of the ITC by the appellants, unlike bank accounts from which money can be withdrawn quickly. The process of utilizing ITC takes time, allowing the revenue authorities to supervise and monitor the proceedings, including the ECL, even during the pre-decisional hearing process.

b) Independent application of mind by the proper officer

- Rule 86A requires the officer to have "reasons to believe" that fraudulent or ineligible Input Tax Credit (ITC) has been availed. Such "reasons to believe" must be formed through the proper officer's own independent inquiry and not based on borrowed satisfaction from another authority's findings. The ECL was blocked by the proper officer due to the fact that he felt compelled to obey the command of another officer. The Hon'ble High Court observed that it was not the manner in which the law expects the power under rule 86A to be exercised. The Hon'ble Court held that when a thing is directed to be done in a particular manner, it must be done in that manner or not at all is the well-established principle of administrative law.

- Even Circular No. CBEC-20/16/05/2021-GST/1552, dated 02.11.2021 ("Circular") outlines the process and requirements for blocking the ECL. The Circular mandates that before disallowing the use of credit, the concerned officer must apply their mind and consider all the facts, including the nature of the fraud or ineligible ITC.

- Blocking an ECL restricts the assessee's ability to utilize the ITC for up to one year. Such action directly impacts the liquidity of businesses and can cripple operations, especially in sectors like scrap dealing, where cash flow and credit utilization are critical. Hence, such a measure must be taken with extreme caution and only when there is concrete evidence of fraudulent transactions. In this case, the absence of such evidence warranted setting aside the blocking of the ECL.

- The onus lies on the revenue to show that the appellants had deliberately availed fraudulent or ineligible ITC however, in the instant case, the ECL of the appellants had been blocked by the respondents without verifying the genuineness of the transaction and a bonafide purchaser cannot be denied ITC on account of a supplier's default and the recipient cannot be made to suffer denial of ITC for the wrong doings of the supplier.

- In this case, the blocking of the ECL was mechanical and lacked the required independent inquiry and fulfillment of conditions for invoking Rule 86A of CGST Rules, rendering the action illegal. The Hon'ble Court noted that the ECL was blocked solely based on communication from another officer (from the investigation wing), without any tangible material to form a belief that the ITC in the appellant's ECL was on account of any fake invoice.

- The Hon'ble High Court emphasized that the power of disallowing debit of amount from the electronic credit ledger must not be exercised in a mechanical manner. Careful examination of all the facts of the case is important to determine cases fit for exercising power under Rule 86A. The remedy of disallowing debit of amount from electronic credit ledger, being extraordinary by nature, has to be resorted to with utmost circumspection and with maximum care and caution.

The Hon'ble Karnataka High Court directed the revenue authorities to reconsider the matter, ensuring compliance with the principles of natural justice and conducting an independent inquiry before taking any further action under Rule 86A.

W&B Comment:

The ruling highlights the original intent behind the use of Rule 86A of the CGST Rules, which allows the blocking of ITC and provides the department a manner in which the power under the rule should be utilized. While the rule is intended to curb fraudulent practices, the power must be exercised with caution and grounded in independent inquiry. Various High Courts across the country, have consistently ruled that there is no legal basis for blocking future credits under Rule 86A where the conditions under the rule have not been met. The present ruling reinstates the necessity of principles of natural justice, even though they are not mentioned in the language of the rule itself. The Hon'ble Karnataka High Court has stated that the department's usual practice of mechanically blocking the ECL based on departmental orders should not be followed. This decision will be helpful for all assesseees where the department has invoked Rule 86A without adhering to the proper procedure and law.