"Can Vendor Defaults Jeopardize Genuine Tax Claims? A Legal and Practical Analysis"

"*Vendor non-compliance is not your liability — and the law says so. This article highlights how to defend genuine claims with evidence and precedent*."

The present controversy arises from a growing departmental practice of treating vendor-side non-compliance (e.g., non-filing of ITR, return mismatches, or other lapses) as a ground to disallow otherwise genuine purchases/expenses in the hands of the assessee. This is being done even where the assessee has placed complete primary evidence on record—tax invoices, delivery/transport proofs, evidences as regard rendering of services, entries in regular books, banking trails, TDS/GST compliance (as applicable), and vendor confirmations. In several recent assessments, assesses are additionally called upon to procure and file the vendor's ITR acknowledgments as a condition for allowance—shifting the enforcement burden for a third party's obligations onto the taxpayer

In indirect taxes (MVAT/GST), the statute expressly links purchaser credit to supplier compliance (e.g., MVAT Section 48(5); CGST Section 16(2)(c)). No comparable statutory hook exists in direct tax. Under the Income-tax Act, deductibility turns on the assessee proving genuineness, incurrence, and business purpose; vendor non-filing, by itself, is not a statutory ground to deny deduction. Courts (including the Supreme Court) have held that additions cannot rest solely on third-party lapses where the assessee's primary evidence is intact.

This approach imports an indirect-tax mindset (MVAT/GST)—where statute text may link credit to supplier compliance—into direct tax where no such statutory linkage exists. Under the Income-tax Act, 1961, deductibility turns on genuineness, incurrence, and business purpose proved by the assessee; a vendor's failure to file its return or pay tax is not, per se, a statutory ground to deny deduction. Persisting with disallowances on vendor default alone, despite full assessee evidence, contradicts settled judicial

discipline and creates disproportionate hardship by penalizing compliant taxpayers for third-party lapses beyond their control.

Questions that arise:

1. Can the Department, absent any statutory mandate, insist that a business assessee must furnish the vendor's ITR proof as a precondition to allowance?
2. Is a vendor's non-compliance, by itself, sufficient in income tax to discredit the assessee's documented purchases/expenses?
3. Do repeated disallowances on this premise erode judicial discipline and risk overreach contrary to binding precede

The Income-tax Act does not condition deductions on vendor ITR filing; once the assessee's onus is discharged with primary evidence, mere vendor non-compliance is insufficient to deny deduction. Any departmental insistence on vendor-side ITR proofs as an eligibility filter is ultra vires, imports an indirect-tax mindset into direct tax without legislative backing, and runs contrary to binding judicial precedent

This case concerns a misapplication of law: business expenditure/purchases, duly supported by invoices, delivery proofs, book entries, banking, TDS/GST (as applicable) and confirmations, are being disallowed solely because the supplier has not filed its ITR/has defaulted. Recent notices further compel assessees to produce vendors' ITR acknowledgments, effectively transferring a third party's compliance burden to the assessee. The Income-tax Act contains no such condition; deductibility depends on the assessee proving genuineness and business nexus, not on vendor tax filings. The proposed disallowance is therefore ultra vires, factually unjustified, and contrary to judicial discipline.

Practical Difficulties Faced by Taxpayers

- Information asymmetry (no statutory right to see vendor's ITR)

  The vendors' return acknowledgements or computation/paid-tax status with counterparties need not be disclosed. PAN/GSTIN/TDS data can be accessed, but evidence of ITR filing is confidential tax data. It is a legal impossibility (lex non cogit ad impossibilia) and privacy contradiction necessitating assesses to obtain it

- Post-transaction attrition & vendor churn:

  Small/seasonal vendors frequently shut shop, relocate, or change key personnel. After completion of supply, traceability drops sharply—emails bounce, phones change, and proprietorships dissolve. Even with genuine follow-ups, obtaining fresh confirmations or tax proofs months/years later is often infeasible.

- Scale constraints in enterprise procurement:

  Large entities deal with thousands of vendors across plants/branches and multi-year frameworks. Tracking each vendor's annual ITR status (which itself updates on rolling statutory timelines) would require disproportionate effort, new systems, and continuous chases—administratively unworkable and not envisaged by the Income-tax Act.

- Timing mismatches built into law:

  Assessment of the purchaser may occur before/around the due dates or processing of the vendor's return, or while vendor proceedings are pending. Making the purchaser's deduction contingent on future/third-party filings is structurally illogical and creates rolling uncertainty.

Limits of available government utilities:

- TRACES/TDS confirms tax deducted/deposited by the assessee, not whether the vendor filed its ITR or paid its own taxes.
- 26AS/AIS of the assessee shows credits/outflows, not the vendor's return status.
- Earlier, taxpayers had a checkpoint via the 206AB utility to verify which vendors had not filed their ITRs for the past two years. Now, there remains no mechanism to trace vendor non-compliance, such as defaults in filing returns, leaving assessees with no recourse. However, Sec. 206AB "specified person" check only flags higher TDS where criteria are met; it does not certify that a vendor has filed the ITR for the relevant year nor does it validate expense deductibility. At best, it's a rate tool—not a vendor-compliance audit

Contracting & confidentiality barriers:

Many vendors (especially larger ones) refuse to share ITR acknowledgements due to confidentiality policies. Procurement contracts typically require tax registrations/invoices, not annual ITR proofs. Renegotiating legacy contracts to add ITR-sharing covenants across the entire vendor base is commercially impracticable.

Evidentiary sufficiency already met by the assessee:

The assessee's primary onus is discharged through: PO/work order, invoice, GRN/DC, gate entry/logistics documents, ledger postings, banking trail, TDS/GST compliance (as applicable), and vendor confirmation (where obtainable). Insisting on vendor's ITR proof adds an extra-statutory condition unrelated to whether the assessee incurred the expenditure for business.

Risk of double jeopardy & cascading prejudice:

If a vendor defaults, the taxpayer ends up losing the deduction even though tax is already paid through TDS, GST, and the purchase price. At the same time, the Department can still recover tax from the vendor, leading to double hardship for the assessee and disturbing fairness in taxation.

Administrative overreach vs. proportionality:

Asking taxpayers to collect vendor ITRs makes them act like enforcement agents for the Department. This is disproportionate, since the Revenue already has strong statutory powers—such as calling information, third-party verification, issuing summons under sections 133(6)/131, or using reassessment and TDS default provisions—to check the vendor directly.

What an assessee can reasonably place on record to show bona fides

Vendor master (PAN/GSTIN/MSME), PO/contract, invoices & GRN/DC, e-way bill/logistics, bank proofs (NEFT/RTGS/UPI), TDS challans & Form 26Q mapping, periodic vendor balance confirmations/emails, and proof of attempts to obtain confirmations (returned mails, courier PODs, call logs). This demonstrates due diligence without assuming responsibility for the vendor's ITR.

Therefore , in practice, the department is increasingly invoking vendor non-compliance to cast doubt on even bona fide claims of taxpayers. Purchases, business expenses, and service payments are all finding

their way under scrutiny - not because the assessee failed in maintaining records or making payments, but because the counterparty may not have discharged its own compliance obligations. This opens up a larger debate - *the practical difficulties that taxpayers face when expected to monitor compliances that may be completely outside their control.*

The Taxpayer's Reality

In effect, taxpayers - despite being fully genuine in their dealings - continue to face notices and disallowances merely on account of vendor non-compliance. Even where they maintain complete documentation such as invoices, payment proofs, bank entries, and confirmations, they are still dragged into the net of suspicion.

Practical hurdles make the situation even worse. Despite of repeated attempts to reach out to vendors, taxpayers often fail due to vendors becoming untraceable, ceasing operations, or simply refusing to co-operate. This leaves no point of recourse for the taxpayer, except being unfairly questioned.

"should a compliant taxpayer be made to suffer for someone else's failure, especially when the taxpayer has discharged its obligations in full?"

Judicial precedents such as CIT v. Odeon Builders Pvt. Ltd. *418 ITR 315* (SC) in which the Supreme Court held that mere non filing of return by the vendor cannot render the purchases as bogus, provided the assessee has proper documentation and Nangalia Fabrics Pvt. Ltd. v. DCIT 220 Taxman 17 (Guj HC) wherein it was held that mere non-compliance or defaults by the vendor cannot render the purchases or transactions as bogus, provided the assessee has proper documentation to substantiate them.

Yet, in practice, we are witnessing the very opposite - a return to the VAT & GST - mindset, where bona fide claims are disallowed not because of lack of evidence, but because of the Revenue's insistence on shifting the burden of enforcement onto taxpayers.

Way to frame the reply (with authorities) ; - Assessee's Evidence, Department's Powers, and Binding Precedents

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- *Affirm your evidence (discharge primary onus) ;-*

State that the assessee has produced a complete contemporaneous trail: PO/contract, tax invoices, GRN/transport/e-way bill, stock/consumption records, ledger postings, bank proofs (NEFT/RTGS/cheque), TDS/GST mapping as applicable, vendor KYC and balance confirmations. Emphasise that once primary evidence is on record, additions cannot rest solely on third-party lapses (such as a vendor's non-filing), per CIT v. Odeon Builders (418 ITR 315 (SC), order 21-Aug-2019), where the Court approved deletion of a purchase disallowance based only on untested third-party material when invoices, transport, accounts and bank payments existed.

Further, Provide a small bundle showing proof of follow-ups for confirmations (emails/letters/courier PODs/call logs). This shows diligence and addresses any "non-traceable vendor" allegation. This approach is consistent with Nikunj Eximp (Bom HC) CIT v. Nikunj Eximp Enterprises (P.) Ltd., [2015] 372 ITR 619 (Bom); also 35 taxmann.com 384 / 216 Taxman 171 (Mag.).—merely because suppliers did not appear, genuine purchases proved by documents and banking cannot be disbelieved.

Also, Draw the attention , that assessments cannot be on conjecture/guess; **Dhakeshwari Cotton Mills (SC)** ***(1954) 26 ITR 775.***—there must be evidence beyond bare suspicion.

- ***Point the AO to proper statutory tools (do not shift burden)***

  The Department itself has strong powers to verify vendors directly under Sections 133(6) (calling third-party information) and 131 (issuing summons). If the AO relies on any adverse third-party report or statement, the assessee must be given a copy and an opportunity to cross-examine. If this is denied, the addition cannot stand. The Supreme Court in *Andaman Timber Industries v. CCE* (2015) 62 taxmann.com 3 and the Bombay High Court in *H.R. Mehta v. ACIT* (2016) 387 ITR 561 held that withholding material or denying cross-examination amounts to breach of natural justice

- ***Anchor in binding precedent (vendor lapse ≠ bogus purchase)***

  (a)<u>Supreme Court:</u>

  ✓ **CIT v. Odeon Builders Pvt. Ltd. (2019) 418 ITR 315 (SC)**

  Disallowance cannot rest solely on third-party material (like Investigation Wing reports) when the assessee has invoices, transport proofs, ledger/confirmations, and banking trail; AO must conduct independent verification and confront the assessee.

- ✓ **Andaman Timber Industries v. CCE (2015) 324 ELT 641 (SC)**

  If the department relies on third-party statements, denial of cross-examination is a fatal breach of natural justice; the order is unsustainable. (Applied routinely in direct-tax contexts for the same principle.)

- ✓ **Dhakeshwari Cotton Mills Ltd. v. CIT (1954) 26 ITR 775 (SC)**

  Additions cannot be made on mere suspicion/guesswork; there must be reliable material—a reminder against blanket disallowances driven only by vendor lapses.

- ✓ **Collector of Customs v. East India Commercial Co. Ltd., AIR 1962 SC 1893**

  Law declared by the High Court binds all subordinate authorities/tribunals; administrators cannot ignore binding precedent—useful to press judicial discipline before AOs/CIT(A).

(b) <u>High Courts— Purchases/Expenses & Vendor Non-Compliance</u>

- ✓ **CIT v. Nikunj Eximp Enterprises (P.) Ltd. [2015] 372 ITR 619 (Bom)**

  Non-appearance/non-traceability of suppliers does not ipso facto make purchases bogus where documents and bank payments exist; deduction cannot be denied on that ground alone.

- ✓ **CIT v. Nangalia Fabrics (P.) Ltd. [2014] 220 Taxman 17 (Guj) (Mag.)**

  Purchases supported by bills, book entries, and cheque payments cannot be treated as bogus merely because suppliers are not traceable or are non-compliant.

- ✓ **PCIT v. Mohommad Haji Adam & Co. (Bom HC, 11-Feb-2019)**

  Even where purchases are suspect, if sales are accepted, the entire purchase cannot be added; restrict to profit element embedded in such purchases. (Use only without prejudice to your primary allowability case.)

- ✓ **CIT v. Simit P. Sheth (2013) 356 ITR 451 (Guj)**

  In alleged "bogus purchase" cases with accepted sales/stock, addition is confined to a reasonable profit rate (often judicially estimated, e.g., 12.5%)—not 100% of purchases. (Again, fallback only.)

- ✓ **CIT v. Bholanath Polyfab (P.) Ltd. (2013) 355 ITR 290 (Guj)**

  Where purchases are from suspect parties but quantitative tally/sales stand, tax only the profit element, not the entire purchase value.

(c) <u>Natural Justice in Tax (supporting)</u>

- ✓ **H.R. Mehta v. ACIT (2016) 387 ITR 561 (Bom)**

  If the AO relies on external material, the assessee must be supplied the material and given cross-examination; additions without this violate natural justice.

<u>Turning Precedent into Practical Submissions</u>

1. Primary rule: allowability despite vendor lapse

One need to begin by asserting that the assessee has discharged the primary onus—PO/contract, tax invoices, GRN/transport/e-way bill, quantitative/stock records, ledger postings, banking trail, TDS/GST mapping, and (where feasible) confirmations. In this posture, supplier non-filing/non-traceability does not, by itself, make purchases bogus. The Supreme Court in CIT v. Odeon Builders affirmed that additions cannot rest solely on untested third-party material when primary evidence stands. The Bombay High Court in CIT v. Nikunj Eximp Enterprises and the Gujarat High Court in CIT v. Nangalia Fabrics echo this: non-appearance or non-traceability of suppliers is not decisive where documents and bank payments exist.

How one writes it:

"Having furnished contemporaneous records and a complete banking trail, the assessee has discharged the statutory onus. Vendor-side non-compliance, per se, cannot negate allowability of otherwise genuine purchases—refer Odeon Builders (SC); Nikunj Eximp (Bom HC); Nangalia Fabrics (Guj HC)."

2. Procedural shield: insist on material + cross-examination

If the Department proposes to rely on any third-party statements/reports, insist that the material be supplied and cross-examination afforded. The Supreme Court in Andaman Timber Industries v. CCE (2015) 324 ELT 641 (SC) / 62 taxmann.com 3 held that denial of cross-examination is a serious flaw

vitiating the order. The Bombay High Court in H.R. Mehta v. ACIT (2016) 387 ITR 561 (Bom) similarly held that material used against an assessee must be provided and cross-examination permitted before drawing adverse inferences. Also request that the AO verify the vendor directly using Section 133(6)/131 rather than shifting that burden onto the assessee.

How one writes it:

"No adverse third-party material can be used without supplying the documents and granting cross-examination; any such reliance is impermissible per Andaman Timber (SC) and H.R. Mehta (Bom HC). The proper course is vendor-side verification under ss.133(6)/131."

3. Without-prejudice fallback: profit element only

Strictly without prejudice to the above, if the authority yet treats some purchases as tainted while sales/stock are accepted, jurisprudence confines the addition to the embedded profit element, not 100% of purchases: PCIT v. Mohommad Haji Adam & Co. (Bom HC, 11-Feb-2019); CIT v. Simit P. Sheth (2013) 356 ITR 451 (Guj); CIT v. Bholanath Polyfab (2013) 355 ITR 290 (Guj). This needs to be used only as an alternative prayer.

How one writes it:

"Without prejudice, if any estimation is nevertheless made, it must be restricted to the gross-profit element embedded in purchases (Mohommad Haji Adam, Simit P. Sheth, Bholanath Polyfab), not a blanket disallowance."

In view of above , if the assessee's records and banking trail are intact, vendor non-compliance alone can't justify disallowance; the department must first share adverse material and allow cross-examination, and even then, with sales accepted, only the profit element—not the full purchases—can be added, so the proposed addition fails both on merits and procedure

Where Do Taxpayers Stand? — the real-world fallout first

Taxpayers today stand in an uneasy position. In many assessments, orders note submissions but do not engage with them—yielding non-speaking findings that label arguments "not acceptable" or

"distinguished" without reasons, rely mechanically on third-party reports, avoid deal-by-deal analysis of documents and banking trails, and ignore requests for vendor-side verification or cross-examination. This illusory consideration shifts a vendor's compliance burden onto the assessee and triggers a predictable cascade: immediate demand with interest choking cash flows; penalty initiation under Section 270A (and, in aggressive cases, Section 271AAC/271AAD when purchases are branded "unexplained" or "false entries"), heightening litigation risk; coercive recovery via Section 226(3) garnishee/bank attachment or Section 245 adjustments—sometimes despite pending stay requests—causing instant business disruption; and a procedural churn of chasing uncooperative or untraceable vendors for ITR acknowledgements, confirmations, or Section 133(6) replies, even though the assessee has no legal right to compel such disclosures. The opportunity cost is real: management time is diverted from operations to paper-chasing, vendor relationships sour, and supply chains strain—all from a third-party lapse, not defects in the assessee's records. The result is an erosion of judicial discipline and natural justice that is often corrected on appeal, but only after avoidable cost, delay, and disruption to compliant taxpayers.

Should taxpayers invoke constitutional remedies in such situations? – A considered view

Ordinarily, when a statutory appeal lies, writ jurisdiction under Articles 226/227 is sparingly exercised. Courts discourage writs as a substitute for appeal. However, where assessment orders are non-speaking, mechanically disallow claims, ignore deal-wise evidence, or rely solely on third-party material without disclosure or cross-examination, the jurisdictional error transcends mere appraisal of facts.

In such cases, writ jurisdiction becomes an appropriate parallel remedy to arrest cascading prejudice in the form of immediate demands, penalties, or coercive recovery. The constitutional anchor is Article 141, which mandates that the law declared by the Supreme Court binds all authorities.

Courts in Odeon Builders (SC), Nikunj Eximp (Bom HC) and Nangalia Fabrics (Guj HC) have held that purchases cannot be disallowed solely for vendor lapses or third-party inputs when the assessee's invoices, stock records, and banking trail are intact. Ignoring these binding rulings amounts to judicial indiscipline. When authorities nonetheless proceed as if the Supreme Court's ratio were optional, taxpayers can legitimately contend that such orders suffer from a constitutional infirmity warranting writ intervention, despite availability of statutory appeal.

Judicial discipline: why precedent must be followed

Judicial discipline is not etiquette; it is a constitutional obligation. Article 141 declares that the law laid down by the Supreme Court binds all courts and authorities. The Supreme Court in East India Commercial Co. Ltd. v. Collector of Customs, AIR 1962 SC 1893 clarified that this binding force extends to quasi-judicial authorities under a High Court's superintendence: they cannot ignore binding precedent or initiate proceedings contrary to it. Within each State, the jurisdictional High Court is next in the hierarchy; its rulings bind revenue authorities operating in that territory. The Bombay High Court in CIT v. Thana Electricity Supply Ltd. (1994) 206 ITR 727 (Bom) crisply explains this order of precedence—Supreme Court > jurisdictional High Court > coordinate fora—and makes clear that administrative convenience or internal instructions cannot override judicial command.

For tax administration, the discipline this imposes is specific. If an Assessing Officer believes a cited judgment is distinguishable, the officer must record clear, cogent reasons demonstrating material factual or legal differences; a bare "not acceptable/different facts" is no answer. Orders that do not engage with authority or evidence are non-speaking, offend the duty to give reasons, and are liable to be set aside/remanded. Equally, departmental circulars or investigation reports cannot dilute a binding ratio; at best they operate subject to court decisions. Where the Supreme Court and jurisdictional High Courts have settled that vendor non-compliance, by itself, does not render purchases bogus when contemporaneous records and a banking trail exist, revenue authorities must apply that law or reasonably distinguish it. Persisting with additions that ignore such precedent is not merely an error—it undermines the rule of law, invites appellate correction, and justifies constitutional scrutiny for failure to adhere to binding judicial authority.

A second constitutional plank is natural justice Articles 14/21. If the department relies on external reports or statements, it must supply the material and allow cross-examination, failure vitiates the order. A third is recovery discipline: writ courts have repeatedly required reasoned stay orders u/s 220(6) and restrained high-handed recoveries—see KEC International Ltd. v. B.R. Balakrishnan (2001) 251 ITR 158 (Bom); UTI Mutual Fund v. ITO (2012) 345 ITR 71 (Bom). Finally, Article 265 - "no tax except by authority of law" supports the grievance that insisting on vendor ITR acknowledgements—which the assessee has no right to obtain and which the Act nowhere prescribes as a condition for deduction—is extra-statutory.

In such fact patterns, the writ prayer typically seeks:

- Quashing/remand of the non-speaking assessment with directions to examine deal-wise evidence and banking trail;
- Interim protection against recovery and a reasoned u/s 220(6) stay per KEC/ UTI MF;
- A declaration that the AO cannot insist on vendor-ITR proofs absent a statutory mandate and must verify vendors directly under Section 133(6)/131 proceedings; and
- Supply of all relied-upon material with an opportunity for cross-examination before any adverse inference.

In short: where authorities do not adhere to Supreme Court law and procedural safeguards, Articles 226/227 offer a focused, constitutional path to neutralize immediate harm and to compel a fresh, reasoned determination consistent with binding precedent.

Way Forward: A Balanced Approach;

The recurring controversy highlights the urgent need for a calibrated framework that balances revenue enforcement with fairness to compliant taxpayers. The Income-tax Act does not envisage making an assessee hostage to a vendor's default; yet, current practices often blur this distinction. A more constructive approach would be for the Department to exercise its extensive powers under sections 133(6) and 131 to verify vendor compliance directly, rather than shifting this burden onto the assessee. Clear guidelines should be evolved to separate sham or unsubstantiated transactions from genuine, documented purchases, with safe-harbour provisions for taxpayers who can demonstrate contemporaneous evidence—purchase orders, invoices, delivery/transport records, banking channels, and tax deductions. At the systemic level, technology platforms such as AIS and TRACES can be leveraged to track vendor defaults without compelling assessees to procure confidential vendor ITR acknowledgements. Such measures would protect bona fide taxpayers, reduce avoidable litigation, and at the same time preserve the Department's ability to act decisively against errant or non-compliant vendors. Ultimately, this balance—protecting the honest while pursuing the non-compliant—is what will strengthen both taxpayer confidence and the credibility of tax administration.

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