Power Upheld, Formula Struck Down: Karnataka High Court on Limits of Capacity-Based Taxation for Pan Masala Under HSNS Act

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1. Introduction

Tax legislation rarely survives its first serious constitutional test without at least a scratch, but few levies have been tested quite as thoroughly, or as quickly, as the Health Security se National Security Cess Act, 2025. Barely months after it came into force, the Hon'ble Karnataka High Court in ***Dhariwal Industries Pvt Ltd Company & Ors. Vs Union Of India & Ors. [TS-229-HC-2026(KAR)-NT]*** delivered what is arguably the first substantive judicial pronouncement on the newly restructured indirect tax regime for pan masala. The batch of petitions challenged the constitutional validity of the Health Security se National Security Cess Act, 2025 ('HSNS Act'), enacted by Parliament to levy and collect cess for specific, identified purposes, along with the Health Security se National Security Cess Rules, 2026 ('HSNS Rules') notified under it. What emerged from the Court's reasoning was a mixed bag for the petitioners and the respondents as the competence of Parliament to legislate and levy the cess was upheld, but the mechanism chosen to calculate that cess, one that taxed machines on their deemed capacity rather than their actual output, was struck down as arbitrary and violative of Article 14 of the Constitution.

2. Factual Background

The petitioners were engaged in the manufacture and supply of pan masala, classifiable under HSN 2106 90 20. The product, once processed, is packed into pouches using pouch-packing machines and sold at the Retail Sale Price. Until the HSNS Act took effect, pan masala attracted GST at the highest slab of 28 per cent, along with the applicable GST compensation cess. That position changed from 1 February 2026, when the HSNS Act introduced a fundamentally different model of taxation which provided that duty computed on the basis of a machine's production capacity, rather than the quantity of pan masala actually produced from it.

3. Submissions on Behalf of the Petitioners

The petitioners' case rested on two broad limbs, the first being that once pan masala stood taxed under the GST framework governed by Articles 246A and 279A, the Union could not have reached for Article 271 to impose what was in substance an additional levy on the same taxable event. A surcharge under Article 271, they argued, can only be superimposed on duties or taxes referred to in Articles 269 and 270 and it has no application to GST levied under Article 246A which is altogether a separate levy under the constitutional structure of the country. Since GST was the only tax borne by pan masala, and GST is specifically carved out of Article 271's reach, the entire foundation of the impugned levy was said to be constitutionally unsound.

The second limb concerned the mechanics of the levy itself. It was submitted that a cess, whatever its constitutional pedigree, cannot be pegged to deemed production at best and it can attach to what is actually produced. Under the impugned scheme, however, the Central Government sought to levy cess based on the number of machines a manufacturer possessed and their **theoretical** output, regardless of what those machines actually manufactured. Such a regime, the petitioners argued, finds no refuge in law, rendering the HSNS Act and the HSNS Rules unconstitutional.

4. Submissions on Behalf of the Respondents

The Union defended the legislation as a constitutionally sound exercise of Parliament's plenary fiscal power, enacted in the public interest to address a sector long associated with tax evasion and serious public health harm. It was submitted that pan masala occupies a category of its own, both for its adverse health consequences and for being among the most evasion-prone commodities in the country.

The Respondents traced the revenue problem to the post-2017 GST era, when pan masala was brought under GST Compensation Cess at ad-valorem rates. Despite the high applicable rates, collections from the sector consistently fell well short of what its productive capacity should have yielded, a gap the Union attributed to large-scale, continuing evasion. The impugned Act, addresses this leakage at its source by shifting the taxable event away from the transaction which can be suppressed or under-reported to machine ownership which cannot be supressed.

Lastly, it was argued that the cess is neither a GST nor a tax properly so called, so Article 246A and the GST Council's jurisdiction has no bearing on it, nor is it a surcharge, hence Article 271 is equally irrelevant. The levy attaches to machine ownership, not to production or deemed production, and the shift to a capacity-based model was described as a considered policy response to the documented failure of transaction-based taxation. The Act it was urged is a valid exercise of Parliament's plenary power under Article 246(1) read with Entry 97 of List I of the Seventh Schedule.

5. Findings of the High Court

5.1 The Statutory Scheme

The Court examined the architecture of the Act and Rules in some detail before turning to the substantive challenges. Section 4 of the Act imposes the levy on machines installed, or processes undertaken, for the manufacture of specified goods listed in Schedule I, computed at the rates in Schedule II in the manner set out under Section 5. "Pan Masala" bearing HSN 2106 90 20 is a specified good under Schedule I. Under Serial No. 1 of Table I to Schedule II, the same cess applies uniformly to every machine with a production capacity of up to 500 pouches, tins or containers per minute, the only variable being the weight per pouch. Higher capacity bands, 501-1000, 1001-1500, and above 1500 pouches per minute, are taxed similarly, at fixed amounts corresponding to each band. Section 5(7) permits **abatement** of cess where a machine remains inoperative for a continuous period of **fifteen days** or more, with Rules 9 and 11 (Chapter III) prescribing the declarations to be filed and Chapter IV, particularly Rules 15 and 16, governing the conditions and formula for such abatement.

The Court's central observation on the scheme was that the levy is not on the product per-se but on the machine and the capacity it is deemed to generate which was not found to be in consonance with the equality mandate of Article 14 as discussed in later part of this article.

5.2 The Arithmetic of Arbitrariness

The Court found the practical consequences of this design difficult to reconcile with fairness. Working through an illustration from the record, it noted that a machine producing 65 pouches per minute, run for eight hours a day over 25 days, would yield 7,80,000 pouches. The cess payable on such a machine came to Rs. 1,01,00,000, and once GST (computed at an effective 1.14 per cent) was added, the total tax burden rose to Rs. 1,09,91,429. Against this, the total MRP realisable from those 31,200 pouches, representing a single 8-hour shift, was only Rs. 31,20,000. The Court held that this **scale of disproportion** between the tax demanded and the value the goods could ever generate went beyond a mere policy decision but violated the arbitrariness doctrine under Article 14.

5.3 The Fifteen-Day Abatement Rule

The Court also took serious objection to Rule 15(a), which allows abatement of cess only where manufacturing remains suspended continuously for **fifteen days** or more. Shorter interruptions, whether from machinery breakdown, non-availability of raw material or labour, or routine maintenance, are common and often unavoidable, yet the Rule affords no relief for them. A manufacturer whose machine lies idle for ten or twelve days still bears the full cess, compounding the loss already suffered from the stoppage itself. The revenue’s defence, that the fifteen-day threshold was a deliberate anti-evasion safeguard meant to weed out spurious claims for shorter suspensions, did not persuade the Court. It held that the provision proceeds on the presumption that assessees are inclined to evade tax, and that administrative convenience in preventing evasion cannot by itself justify so blunt and arbitrary a threshold, particularly where genuine hardship is left without any alternative remedy. The Rule was accordingly held to operate arbitrarily and to violate Article 14.

5.4 Uniform Cess for Dissimilar Capacities

The sharpest constitutional infirmity, however, lay in the flattening effect of the capacity slabs. Because Schedule II charges the same cess on every machine capable of producing "up to 500 pouches per minute," a manufacturer whose machine can produce only 100 pouches per minute pays exactly the same cess as one whose machine can produce 500. The levy, in other words, is calibrated not to what a machine actually produces, nor even realistically to what it is likely to produce, but to the outer capacity of the slab within which it happens to fall. From the illustrations placed before the Court by the petitioners, most of the machines in use fell well short of the 500-pouches-per-minute ceiling, yet were taxed as though they operated at that ceiling. **The Court held that treating manufacturers with plainly dissimilar production capacities as equals, purely for administrative convenience, offends the equality guarantee under Article 14**.

5.5 Precedents on Arbitrary Classification

In reaching this conclusion, the Court drew on settled Supreme Court authority. It relied on ***Kunnathat Thatehunni Moopil Nair v. State Of Kerala*, 1960 SCC OnLine SC 7**, and ***State Of Kerala v. Haji K.Kutty Naha, 1968 SCC OnLine SC 122*** , both of which hold that a uniform rate of tax applied indiscriminately to dissimilarly situated persons or transactions results in discrimination and falls foul of Article 14. It further noted that this line of authority on arbitrariness in fiscal legislation stands approved by the nine-judge Constitution Bench in ***Jindal Stainless Steel Limited v. State Of Haryana, (2017)*** . Applying these principles, the Court held that it had "no option" but to find the impugned Act and Rules discriminatory and violative of Article 14, given the disparity inherent in the method of calculating the cess.

5.6 Legislative Competence: Upheld

Notably, the challenge to Parliament's very competence to enact the HSNS Act was rejected outright. The Court **affirmed** that the Union Parliament possessed the legislative power to enact a law levying cess for the stated purposes. What failed was not the power to tax, but the method chosen to quantify it. The Court held that basing the levy on an assumed, deemed quantity of production, rather than what was actually manufactured, was unreasonable and vague, and fell foul of Article 14 to that extent. Consequently, the Act was held unconstitutional only insofar as its calculation mechanism was concerned, and the Rules, being dependent on that mechanism, fell with it. Importantly, the Court clarified that this outcome did not foreclose the revenue's ability to legislate afresh, bearing in mind the observations recorded in the course of the judgment.

6. Conclusion

The ***Dhariwal Industries*** ruling is a reminder that constitutional validity and administrative wisdom are not the same enquiry, and that a legislature can win one while losing the other. Parliament's power to reach into a notoriously evasion-prone sector and design a fiscal instrument around machine capacity was never seriously in doubt once tested against Entry 97 but what could not survive the scrutiny of the Court was a formula that taxed a 100-pouch machine as though it were a 500-pouch machine, and left no room for the ordinary, unavoidable idle days that come with running any factory.

Administrative convenience, however pressing the evasion problem, is not a separate constitutional category in our constitution and it cannot override the guarantees and limits the Constitution places on how a levy may be designed, no matter how efficient or elegant the technique appears on paper. This is, after all, the logic of the grundnorm i.e., the Constitution is the source from which every taxing power flows, and no statute, however fashioned to close a loophole, is entitled to a shortcut around it.

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