

EY Tax Alert

SC holds warranty replacement by dealer against credit note issued by manufacturer is exigible to sales tax

Executive summary

This tax alert summarizes the recent ruling¹ of the larger bench of Supreme Court (SC) on whether replacement of defective parts of cars under warranty by the dealer, against credit note issued by the manufacturer, is exigible to sales tax.

Earlier, SC in the case of Mohd. Ekram Khan², had concluded that such transactions were taxable as the manufacturer had made payment for the parts by issuing credit notes to the dealers. Pursuant to the same, Revenue passed orders demanding sales tax on such transaction undertaken by various dealers.

Divergent rulings were passed by various High Courts (HC) on the above issue and hence, cross appeals were filed before the SC to decide the correctness of the judgement in case of Mohd. Ekram Khan (*supra*).

The key observations of the SC are:

- ▶ A perusal of the definition of "credit note" from various dictionaries would clearly indicate that the same, issued by the manufacturer in favor of a dealer, is a valuable consideration within the definition of "sale" as per Section 2(g) of the Central Sales Tax Act, 1956.
- ▶ In case of warranty replacement as in the present scenario, there was transfer of property between the dealer and the customer on one hand and receipt of a valuable consideration from the manufacturer on the other, in the form of a credit note. Therefore, the same amounts to sale.
- ▶ However, sales tax cannot be levied where the dealer simply receives spare parts from the manufacturer to replace a defective part under a warranty.

Accordingly, SC upheld its judgement in the case of Mohd. Ekram Khan (*supra*) and held that the credit note issued by manufacturer to a dealer for replacement of defective parts pursuant to a warranty agreement is exigible to sales tax under the respective sales tax enactments.

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¹ 2023-TIOL-66-SC-CT-LB

² (2004) 6 SCC 183

Background

- ▶ Assesseees in the present case are dealers of motor vehicles. In the normal course of business, the manufacturer would sell vehicles and spare parts to the assessee, who would then sell such goods to customers.
- ▶ Separate warranty agreements existed between the manufacturer and the ultimate customers to whom such goods were sold.
- ▶ In case of warranty claims raised by customers, assessee, on behalf of the manufacturer, replaced defective parts from their stock purchased from such manufacturer.
- ▶ After receiving the defective parts, the manufacturer issued credit notes for the price at which the parts were initially sold to such assessee. No tax was paid by assessee on the above transactions.
- ▶ On similar factual matrix, Supreme Court (SC) in the case of Mohd. Ekram Khan³ concluded that such transactions were taxable as the manufacturer had made payment to its dealer by issuing credit notes for replacement of defective parts during the warranty period.
- ▶ Pursuant to the same, Revenue passed orders demanding sales tax on such transaction undertaken by the assessee.
- ▶ Divergent rulings were passed by various High Courts (HC) on the above issue and hence, cross appeals were filed before the SC by Revenue as well as the assessee.
- ▶ Consequently, the division bench of the SC referred the matter to the three-judge bench to decide the correctness of the judgement in the case of Mohd. Ekram Khan (*supra*).

Assessee's contentions

- ▶ The decision in the case of Mohd. Ekram Khan (*supra*) struck a discordant note against the well-established principle that the cost of warranty was included in initial transaction of sale and was not taxable separately⁴.
- ▶ As per the SC decision in the case of Gannon Dunkerley & Co⁵, the crucial elements of a tax-exigible sale transaction are:
 - ▶ The existence of buyer and seller
 - ▶ The existence of an agreement for title transfer
 - ▶ Monetary consideration for such title transfer
 - ▶ Property in goods must pass

The spare parts in the present case are supplied free of charge to the customers by the assessee. The substance of the transaction remains to be the discharge of a warranty obligation assumed by the manufacturer, and through him, the assessee.

As such parts are supplied by the assessee on behalf of the manufacturer, credit is deservedly given to them.

Further, Revenue has wrongly assumed that the supply of spare parts to the customer is a sale made to the manufacturer though the title is being transferred to the customer.

- ▶ As per Section 12(3) of the Sale of Goods Act, 1930, a warranty is a stipulation collateral to the main purpose of the contract. Therefore, replacement of spare parts during the warranty period does not constitute a sale.
- ▶ Even if the present transactions are assumed to be that of a sale between manufacturer and assessee, the same has to be treated as sales return as accounted by the manufacturer.

Further, sales return beyond statutory time limit does not lose its character of return. The only consequence could be that selling dealer may not be able to claim the deduction from gross turnover.

Revenue's contention

- ▶ The presence of a manufacturer's warranty on the car sold by assessee does not make any difference to whether the transaction of replacement of defective goods satisfies the elements of sale or not.
- For instance, when a customer purchases a car without warranty and takes an insurance, the expenses on the replacement of defective parts are reimbursed to the dealer. Yet, the transaction is understood as a component of the taxable turnover of such dealer. A similar rationale can be applied in the present case as well.
- ▶ Further, the present case did not involve an exchange of the manufacturer's spare parts with customer's defective parts. Instead, the parts replaced were purchased by the assessee from the manufacturer.

The ingredients of sale ought to be considered complete when goods are transferred to the customers and payment is received from the manufacturer.

- ▶ The dealership agreement between the assessee and manufacturer is a composite document and it includes *inter alia* conditional agreement to sell the spare parts back to the manufacturer in case of warranty claim by the customer.
- ▶ All the elements of sale are complete since there is a seller and a buyer, *i.e.*, assessee and manufacturer; valuable consideration was paid by the manufacturer in the form of credit notes; and the transfer of property in goods is taking place to the nominee of the manufacturer, *i.e.*, car purchaser.

³ (2004) 6 SCC 183

⁴ (1972) 4 SCC (N) 1, (1979) 43 STC 52 (Delhi), 1986 (61) STC 244 MP and (2001) 122 STC 285

⁵ (1959) SCR 379

- ▶ Therefore, the decision in the case of Mohd. Ekram Khan (*supra*) deserved affirmation.

SC ruling

- ▶ When a customer during the warranty period approaches the dealer for the replacement of a defective part, the dealer could resort to the following:
 - ▶ Request the manufacturer to supply the defective part for replacement. In such case, the manufacturer may,
 - i) being a manufacturer of spare part, send the same from his factory,
 - ii) purchase the same from another manufacturer, by paying requisite tax, or
 - iii) purchase the same from open market, by paying requisite tax.
 - ▶ Purchase the spare part from open market, by paying requisite tax.
 - ▶ Replace the spare part from the stock maintained in his showroom.

In the first situation, there is no investment made by the dealer on the said part. The dealer merely acts on behalf of the manufacturer, pursuant to the warranty.

In the second and the third scenario, the dealer has invested on the spare parts. It has every right to sell such a part and seek return on his investment. Since it does not "sell" the part to the customer and uses the same in pursuant to a warranty, the manufacturer issues credit notes to recompense the dealer.

- ▶ In case of warranty replacement, there is transfer of property between the assessee and the customer on one hand and receipt of a valuable consideration by the assessee from the manufacturer on the other, in the form of a credit note.
- ▶ As per Section 2(g) of the Central Sales Tax Act, 1956, "sale", with its grammatical variations and cognate expressions, means any transfer of property in goods by one person to another for cash or deferred payment or for any other valuable consideration.

When a dealer uses one of the spare parts from his stock for replacement of a defective part under warranty, he is given a monetary benefit in the form of a credit note. A perusal of the definitions "credit note" from various dictionaries would clearly indicate that same issued by a manufacturer in favor of a dealer is a valuable consideration within the definition of "sale".

- ▶ The aforesaid transaction may be juxtaposed with the transaction of sale of such parts to the customer *de hors* a warranty. In such an event the assessee would have collected the sales tax along with the price and remitted same to the Revenue.

Merely because the assessee is acting as an intermediary or on behalf of the manufacturer pursuant to a warranty and receives a recompense in the form of

a credit note, the same cannot escape liability of tax under the respective Sales Tax Acts.

- ▶ It is also necessary to take into consideration that all the credit notes received by the assessee are not indicative of the value of the spare part supplied by the assessee to the customer under a warranty. The same could also be for rendering a service under the dealership agreement. In such case, service tax may be leviable to the extent of the value of service provided.
- ▶ Accordingly, SC upheld its judgement in the case of Mohd. Ekram Khan (*supra*) and held that the credit notes issued by manufacturer to assessee for replacement of defective parts pursuant to a warranty agreement is exigible to sales tax under the sales tax enactments of the respective States.
- ▶ However, sales tax cannot be levied where the assessee simply receives spare parts from the manufacturer to replace a defective part under a warranty.

Comments

- This ruling is likely to impact all the businesses where warranty on goods is provided by the manufacturer, but the same is fulfilled by the dealer.
- In the factual scenario of the given case, issuance of credit note by the manufacturer or invoice by the dealer for replacement of defective part could be a revenue neutral situation under GST. However, department may invoke tax demand against dealers where the manufacturers have issued the credit notes.
- SC has clarified that there may be no tax where the manufacturers supply parts free of charge to the dealers to fulfill warranty obligations. Businesses may accordingly plan their warranty stock requirement and maintain separate identification of such stock procured free of cost from the manufacturer to substantiate no tax position.

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