



Sales tax on credit notes issued to dealers for spare parts replaced under warranty

Tata Motors Limited vs. The Deputy Commissioner of Commercial Taxes (SPL) & Anr¹

A three-judge bench of the Supreme Court of India ('SC') upheld its earlier decision in case of *Mohd. Ekram Khan & Sons*² and held that a credit note issued by a manufacturer to a dealer, to compensate the latter for replacement of parts supplied under warranty, on its behalf, is a valuable consideration (received by the dealer) and so, leviable to sales tax.

Background:

- The SC in 2004, in the case of *Mohd. Ekram Khan* (supra) held that a credit note issued by a manufacturer to a dealer of automobiles, in lieu of the replacement of a defective part, pursuant to a warranty agreement being collateral to the sale of the automobile, is exigible to sales tax under the Sales Tax enactments of the respective States. The said judgement was rendered in the context of General Sales Tax Law of Uttar Pradesh.
- Appeals before the Apex Court arose from the judgements of various High Courts both, following and distinguishing the ruling in *Mohd. Ekram Khan*. In these circumstances, reference was made by a division bench to a three-judge bench of the SC for

revalidating the correctness of ruling in the case of *Mohd. Ekram Khan*.

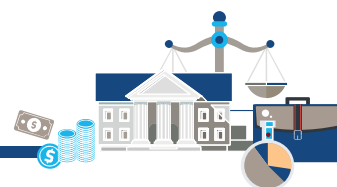
- Of the 34 cases before the SC involving similar questions, the facts of one of the parties viz. M/s, Marudhara Motors was taken up for discussion and analysis.

Facts of the case:

- M/s Marudhara Motors ('dealer') is a dealer of Tata Motor ('manufacturer'). Apart from the usual business of purchase & sale of automobiles and spare parts, the dealer also provided free of cost replacement of defective parts to the customers, in pursuance of a separate warranty arrangement provided by the manufacturer.
- In cases of warranty claims, the dealer replaced defective parts with the new ones, available in stock and returned the defective parts to the manufacturer. Towards this activity, the manufacturer issued credit notes to the dealer for an amount equivalent to cost of spare parts (replacements parts that were defective). This practice of using spare parts from its own stock was followed so as to avoid delay in delivery and for sake of convenience of the customer.

¹ TS-227-SC-2023-VAT

² (2004) 6 SCC 183



Findings of the SC:

- There can be three scenarios for a dealer, in case of a warranty service arrangement:
 - 1) Dealer may request the manufacturer to provide the spare parts for fulfilling the said replacement request (here the dealer receives the spare parts directly from the manufacturer and uses it as a replacement of defective parts, merely acting as an agent), or
 - 2) Dealer may purchase the spare parts from open market by paying taxes and replaces the defective parts with these bought outs.
 - 3) Dealer may replace the defective parts from his own stock of spare parts.
- In situations (2) & (3) above, the dealer has invested in the stock and supplies it, on behalf of the manufacturer, and in turn is compensated by the manufacturer, in form of credit note.
- There is no question of sales or tax levability as far as first scenario, (1) above, is concerned. However, the issue lies in the other two scenarios ((2) and (3) above), whether issuance of credit notes can be considered as a valuable consideration (for the dealers), and, in a warranty service arrangement, can it be construed as the “sale” to the manufacturer, where the dealer replaces defective spare parts on its own accord.
- “Sale”, generally, means any transfer of property in goods by one person to another for cash or deferred payment or for any other valuable consideration.
- The expression “valuable consideration” is not defined in the State Sales statutes. It has wide connotation. ‘Other valuable consideration’ must be monetary in nature. It was observed that the nature of consideration, that is in the form of a credit note is also monetary in nature. Moreover, valuable consideration is not only money paid or promised to be paid but, it is something more, in this case “credit note”.
- The amount shown in the account of the dealer in the form of a credit notes is nothing, but price received for a sale of a spare parts by the dealer.

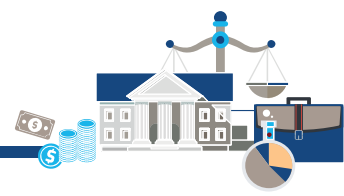
- If the manufacturer purchased the spare parts from the open market, for the purpose of replacement of the defective parts, the manufacturer would have paid the applicable sales taxes. Similarly, if the spare parts are provided by the dealer from his own stock, which are later reimbursed in the form of credit notes, the transaction is as good as sale of spare parts to the manufacturer.
- Merely because the dealer is acting as an intermediary on behalf of the manufacturer, pursuant to a warranty and receives recompense in the form of a credit note, the transaction cannot escape liability of tax.
- The situation is dissimilar from a case where the dealer has received a spare part from the manufacturer to replace a defective part, under a warranty collateral to the sale. Such transactions will not be exigible to Sales Tax, it was clarified. Further, if the dealer receives consideration for the purpose of replacement services rendered by it, under the dealership agreement, such consideration is not sale transaction and so not liable for Sales Tax.

Decision:

- The SC held that the judgment of the Court in **Mohd. Ekram Khan** does not call for any interference, and
- Credit notes issued by a manufacturer to a dealer, so as to compensate the latter for replacement of defective parts (that were supplied pursuant to a warranty arrangement, on its behalf), is valuable consideration (received by the dealer) hence, leviable to sales tax.

Dhruva Comments

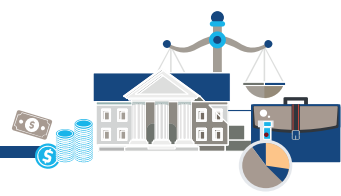
Post the **Mohd. Ekram Khan** decision, contradictory rulings were pronounced by various High Courts, wherein it was reasoned (and held) that cost of warranty was included in the initial transaction of sale of automobiles and was not taxable separately. Further, warranty obligations were being discharged on free of cost basis and there was no consideration involved.



Assessees who had benefited by the favourable decisions in the past, may, have to face legal repercussions after this SC judgment Cases that have become time-barred will not be disturbed.

This ruling will have ramifications in the GST regime too and have precedent value. When a dealer provides replacement parts under a warranty arrangement, from its own stock and seeks recovery from the manufacturer by way of credit notes liability to GST cannot be ruled out.

Interestingly, the GST law creates taxability in situations involving consideration in kind. Hence, part to part replacement could be construed as exigible in view of the ratio of this ruling.



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