

Tax Flash News

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Credit Note issued by a manufacturer to a dealer for auto parts replaced under warranty is a valuable consideration

The Supreme Court of India, in the year 2004, in the case of Mohd. Ekram Khan & Sons¹ had upheld that payment received through credit notes for replacement of defective parts under warranty amount to sale. The correctness of the observations made in this case was challenged. In this background and on a reference made by a Bench of two judges to a Bench comprising of three judges, the Supreme Court held² that the judgement of this Court in the above-referred case does not call for any interference. It reiterated that a credit note issued by a manufacturer to a dealer is a valuable consideration within the meaning of the definition of sale and hence exigible to sales tax under the respective State enactments in a situation where the dealer replaces defective part of an automobile out of its own stock.

Facts of the case

- Assessee-dealer has entered into a dealership agreement with the manufacturer to sell vehicles and replace warranty goods to the customer. A separate warranty agreement exists between the manufacturer and the ultimate customer to whom the assessee sells vehicles.
- In the normal course of business, the manufacturer sells vehicles and spare parts to the assessee-dealer against Form C. Thereupon, the dealer sells these goods to customers by collecting local sales tax. In case of warranty claims raised by customers due to the emergence of defects in some parts, such parts are replaced free of cost by the dealer out of its own stock to avoid delay in first securing

such parts from the manufacturer and then replacing the same. The defective part is returned to the manufacturer from whom the dealer had purchased the same earlier. The manufacturer issues a credit note, thereby crediting the running account of the dealer, which is maintained for sale transactions, at the price at which the spare part was initially sold to the dealer.

- Pursuant to the decision in the case of Mohd. Ekram Khan (supra), the assessing authority, invoked the power of reassessment under the Rajasthan Sales Tax Act, 1994. The matter was taken up by the Rajasthan Tax Board, which set aside the decision of lower authority on the grounds that the facts of the case are distinguishable from the facts in Mohd. Ekram Khan. The Rajasthan High Court affirmed the order of the Rajasthan Tax Board.
- Civil appeals from the above judgment and other High Courts, who had taken divergent views, were filed before the Supreme Court. A Reference Order dated 5 December 2019 was passed by a Bench of two judges referring the appeals to a Bench comprising of three judges to decide whether the case mentioned above has been correctly decided or not.

Petitioner(s) contentions

- Credit note is not a sale price or valuable consideration as the character of credit is not towards the price of the newly replaced part but issued by the manufacturer to the dealer to acknowledge the diminution of the original sales price.
- The property in the replaced part passed merely as an incident of the performance of the manufacturer's warranty obligation, which forms a part of the original sale of the automobile.

¹ Mohd. Ekram Khan & Sons v. Commissioner of Trade Tax, U.P. [[2004] 136 STC 515 (SC)]

² Tata Motors Ltd. v. The Deputy Commissioner of Commercial Taxes (SPL) & Anr. [TS-227-SC-2023-VAT]

- Enforcement of a contractual right for getting a free replacement in exchange for a defective part was neither any purchase by the buyer nor a sale to such buyer.
- Even if the present transaction is assumed to be a sale between manufacturer and dealer, the same must be treated as a purchase return and not exigible to sales tax.

Revenue's contentions

- The presence of a warranty on the car sold by the dealer does not make any difference to whether the transaction of replacement of defective goods satisfies the element of sale or not.
- The transaction do not involve an exchange of the manufacturer's spare parts with the customer's defective parts. It is also not a stock transfer from the manufacturer to the dealer.
- The concept of sale and purchase return applies to the same goods. The present facts pertain to defective goods.
- All elements of sale (i.e., there is a seller and a buyer, valuable consideration is paid by the manufacturer in the form of credit notes and there is transfer of goods to the purchaser) are present in the impugned transaction.

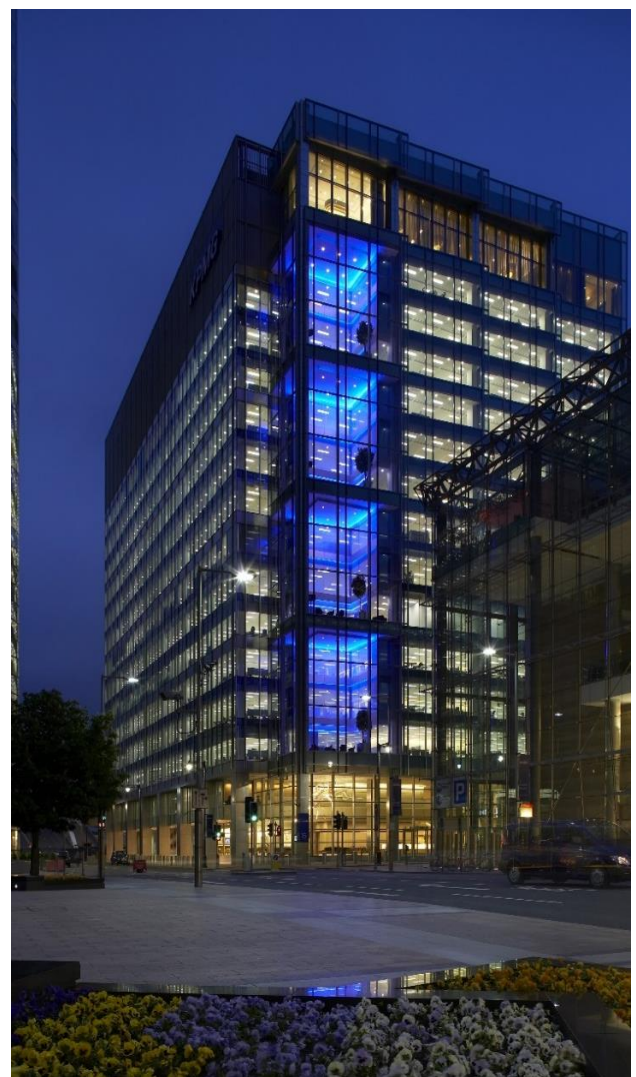
Supreme Court's decision

The Supreme Court of India, after analysing several other judgements, clarified that the judgement in the case of Mohd. Ekram Khan has been correctly rendered. Accordingly, appeals filed by dealers are dismissed, while those filed by revenue are allowed. Prominent inferences pronounced by the Supreme Court are as follows:

- The judgement of Mohd. Ekram Khan applies in a situation where the dealer replaces a defective part out of its own stock or when the same is purchased by the dealer in the open market. In such a situation, a credit note issued by a manufacturer to the dealer is a valuable consideration within the meaning of the definition of sale and hence exigible to sales tax under respective State enactments.
- The judgement of Mohd. Ekram Khan does not apply to a case where the dealer has simply received a spare part from the manufacturer to replace a defective part therein under a warranty collateral to the sale of a vehicle.

Our comments

This judgment is delivered in the context of erstwhile state-specific VAT laws wherein the incidence of the levy was on 'sale'. Pursuant to this judgement, it is important to review the taxability of transactions involving warranty claims under GST since the incidence of the levy is on 'supply', which includes 'sale', but the term 'sale' is not defined in GST law, unlike the erstwhile VAT laws. Moreover, there is a specific section 34 in GST law on the issue of credit notes which prescribes that where goods are returned by the recipient, or goods are found to be deficient, the supplier of such goods may issue credit notes.



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