Karnataka AAAR holds supply of goods and services under warranty contract as composite supply, with principal supply being services; infers the term "recipient of supply" as the person obligated to make payment to supplier under the contract

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In brief

The Karnataka bench of the Appellate Authority for Advance Ruling (AAAR) has recently held [1] that the activity of repair and servicing of vehicles under a warranty contract is a composite supply and the principal supply is supply of services. Importantly, the order also concluded that the person contractually obligated to make payment for the supply should be the recipient of service.

In detail

Facts

- The appellant is a distributor of branded trucks on a principal-to-principal basis in India. It also provides warranty and other after sales support services to its customers in India. For the trucks sold by the appellant, it gives a standard warranty of one to two years to its customers, the cost being included in the original sales price. Against such warranty claim, the appellant carries out servicing and repair of the vehicles sold and even replacement of defective parts, where required.
- For the costs incurred against such warranty claims, the Distribution Agreement entitles the appellant to a reimbursement from its foreign group company as per the agreed international warranty terms.
- In an application filed before the Karnataka Authority for Advance Ruling (AAR), the question raised by the appellant was whether the supply to the foreign group company is a supply of services, and if yes, whether it can qualify as "export of services," and hence, zero-rated under goods and services tax (GST) law.
- The AAR held that the transaction constitutes a composite supply of goods and services with the principal supply required to be determined based on the nature of each case. It also held that the transaction does not qualify as export, as the "recipient of service" in this case is the customer (located within India) who claims the warranty service and not the foreign group company.

Appellant's contentions

- The definition of "consideration" under GST is only an inclusive definition and it needs to be understood *vis-à-vis* the Indian Contracts Act, 1872, which requires the promisor and promisee to have been in a contractually bound obligation for the consideration to flow. In the present case, it is necessary that the foreign group company makes the reimbursements and the customer in India has no contractual right to enforce the performance of the warranty obligations of the appellant.
- The appellant recovers the cost of providing such services to its customers in India from the foreign group company and that contract is in complete distinction to the original sale agreement between the appellant and the customers in India.

[1] Order No. KAR/AAAR-14-B/2019-20, dated 9 February 2020

- The activities undertaken by the dealer during the warranty period is for meeting the obligations of the manufacturer, and is therefore, a supply made to the manufacturer, although the beneficiary may be the customer/ buyer of the vehicles.
- The transaction between the appellant and the foreign group company is a zero-rated supply in as much as the place of supply of the service is outside India and all other conditions for a transaction to qualify as "export of service" stand satisfied.

AAAR's order

Observations on "recipient of service"

- The AAAR observed that the moot question is with respect to the "recipient of service," i.e., whether the recipient is the customer in India who approaches the appellant or the foreign group company who reimburses the cost in this regard. The AAAR held that, as the appellant performs repairs at the behest of the foreign group company and not that of the customer, the recipient of the service shall be the foreign group company and not the customer, as held by the AAR. In this context, the AAAR has given the following rationale:
  - An established trade practice, warranty is a commitment given by the manufacturer to repair, service, provide replacement or give refund for any defect in the product sold, within the agreed timelines. Moreover, manufacturer factors the cost of such repairs, etc., into the cost of the products sold.
  - The given case substantiates this fact, considering that the appellant sends a "*Technical Failure Analysis Report*" to the foreign group company to pre-approve every customer's warranty claim.
  - A combined reading of the definition of "recipient of supply" with "consideration" as per the Central Goods and Services Tax Act, 2017 makes it clear that the person required to make payment for fulfilling an obligation is the recipient of the service.

Other observations

- On the question of classification, the AAAR categorically agreed with the appellant's submission that the transaction is a composite supply of goods and services, with the principal supply being supply of services.
- On whether the repair and servicing activity qualifies as "export," the AAAR has refrained from commenting on it, as it requires the determination of "place of supply," which is outside the jurisdiction of the AAAR.

The takeaways

This is a welcome ruling from the AAAR to treat the repair activity as a composite supply with the principal supply being that of "service." It is equally heartening to see that the AAAR has extensively relied on the contractual arrangement and the underlying intention of the parties to identify the "recipient of supply," and not merely interpret the question based on the ultimate beneficiary of such supply. The linking of the definition of "recipient of supply" with "consideration" in the above ruling is noteworthy.

This ruling, although not binding, may help several industry players providing warranty services on behalf of/ to customers of foreign suppliers in India to evaluate positions with regard to export, classification, zero-rating, etc.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor.

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