VAT treatment of cost recharges for warranty repairs 2/16/22

On 24 February 2022 the Court of Justice of the European Union (CJEU) ruled on a dispute over the VAT treatment of costs the customer had recharged to the supplier of goods under the contract during the warranty period. This article explores what the CJEU found and how those findings can be put into practice.

The main proceedings and preliminary questions

Suzlon Wind Energy Portugal, a Portuguese company ("PortCo") operating in the wind energy sector, had entered into a contract to buy a wind generator with ancillary equipment from Suzlon Energy Inde, an Indian company ("IndCo"). The contract required the supplier to provide a warranty for manufacturing faults in all the components for a period of two years after the contract was concluded. The supplier undertook to reimburse the customer's expenses incurred in repairing and replacing faulty parts.

The equipment bought by PortCo developed faults in the middle of the warranty period. The companies entered into a service agreement for repairing or replacing the faulty parts, under which PortCo would set up an equipment repair unit in Portugal and replacement parts would be transported from India to Portugal.

PortCo repaired or replaced the faulty parts after buying the necessary materials and services from third parties, who issued invoices for their goods and services. PortCo deducted the VAT on the goods and services it had acquired. PortCo issued debit notes titled "discrepancy statements" for these costs to IndCo. The debit notes neither charged VAT nor stated the reason for VAT exemption.

The Portuguese tax authority claimed that the transaction is a taxable supply of services. PortCo believed, however, that this is a recharge of costs the company incurred in performing a task to be carried out by IndCo. This caused a dispute, and the case landed in court.

The CJEU's findings

The CJEU stated that the point at issue is whether the taxable person's transactions, which resulted in the debit notes being issued/booked and the input VAT deducted, represent a supply of services for a consideration for VAT purposes if, firstly, the goods and services acquired for the repairs involved goods covered by a warranty and, secondly, the taxable person recorded those transactions as profitless.

The CJEU also stated that for a transaction to be taxable under Directive 2006/112/EC, the five criteria set out below must be met at the same time:

1. The transaction is a supply of services.
2. It has been made for a consideration.
3. It has taken place in a member state.
4. It has been made by a taxable person.
5. The taxable person has acted as such.

Member state (3) and taxable person (4)

The transactions took place in Portugal, a member state, and PortCo was a taxable person registered for

Portuguese VAT. The CJEU found two of the criteria are met.

Taxable person acting as such (5)

The CJEU stated it must be established whether PortCo indeed made those transactions as a taxable person. In other words, whether, firstly, the company made them in the course of its taxable business, not as a private person, and, secondly, whether the company is the true legal performer of those transactions. For the transactions covered by the debit notes, this means checking whether PortCo was acting as a taxable person in its own name, or in IndCo's name and interests. To establish this, the court said we need to look at how the transactions are recorded in PortCo's books and whether the company recognises them as its own expenses, or whether those costs are posted in suspense accounts.

It followed from the circumstances of the case that PortCo carried out the repair or replacement services in Portugal, using local suppliers and service providers. All the invoices had been issued in PortCo's name. PortCo deducted the VAT appearing on the invoices, which should therefore be treated as input VAT associated with the transactions recorded according to the debit notes. Moreover, PortCo had not posted the repair/replacement costs in suspense accounts to set them apart as costs related to another company.

So the CJEU found PortCo's actions demonstrate it was acting as a taxable person.

Supply of services (1)

Article 24 of Directive 2006/112/EC provides that a supply of services is every transaction that is not a supply of goods. Accordingly, if we are to identify a service, we must consider the terms of the contract. It followed from the case files that the contract for repair and replacement works (titled "agreement for supply of services") and the debit notes stated that PortCo is the service provider and IndCo is its customer. The CJEU added that transactions like those examined in the main proceedings cannot be considered equivalent to faulty parts being returned to the supplier for repairs or replacement, because the supplier had asked PortCo to carry out a certain task aimed at fulfilling the supplier's warranty.

Consideration (2)

The CJEU noted that services are supplied for a consideration only if there is a legal relationship between the supplier and the customer that involves a reciprocal performance, and the payment the supplier receives is actual consideration for an identifiable service supplied to him.

This situation involved a legal relationship, the supplier's consideration matched the debit notes, and the services, in particular the support provided to repair or replace the equipment, fitted the definition of "an identifiable service supplied to the customer." The CJEU also stated that a debit note is not a reason for not treating it as a consideration and it is irrelevant that the consideration does not take the form of a payment. It is also irrelevant that PortCo recharged its costs to IndCo without a markup, because business can be done for a price that is higher or lower than cost.

Accordingly, the CJEU found that the transactions, where both the supplier and the customer can be identified and that are recorded under a name confirming they are services in nature, and for which a consideration has been paid in the form of debit notes, represent a supply of services for a consideration. It is irrelevant that the taxable person does not make a profit and that there is a warranty for the goods that needed those services.

The CJEU also stated that the existence of a warranty for the goods supplied would affect the supply of services for a consideration only if one of the five criteria mentioned above were affected. For example,

the service provider could have dealt with the acquired goods and repair/replacement works in another person's name and interests and recorded the relevant amounts in suspense accounts without recovering the input VAT, and named on the orders and invoices the company for which the goods were acquired and works carried out. The repairs situation here is different from one in which faulty goods are replaced.

Putting CJEU findings into practice

The findings of the CJEU's ruling offer some insight into criteria that must be assessed to determine whether in unclear situations a taxable supply of services or a transaction outside the scope of VAT has taken place.

In addition to the transaction being made by a taxable person in his member state, it is important to assess whether the expenses have been incurred in the taxable person's own name or in another person's name and interests, and what accounting treatment has been applied. A taxable transaction also needs a consideration, but neither its amount nor its method of payment is a decisive factor.