COMMISSIONER OF CUSTOMS

v.

M/S FERODO INDIA PVT. LTD.

(Civil Appeal No. 8426 of 2002)

FEBRUARY 21, 2008

(S.H. KAPADIA AND B. SUDERSHAN REDDY, JJ.)

Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 – Rule 9(1)(c) – Price of imported goods – Inclusion of technical know how fees and royalty – Technical assistance and trade mark agreement between buyer-licensee and foreign collaborator-licensor – Under the agreement, licensee permitted to manufacture licensed products – It was to import raw material from licensor and to pay license fee and royalty – Department loading CIF value of imported goods with know-how fees and royalty – Tribunal holding that know-how fees and royalty related to licensed products to be produced in India and not to the imported goods – Held: Correct – On reading the agreement in entirety, there was no nexus between royalty/licence fees payable for know-how and goods imported for manufacture of licensed products – Department was to examine both the price arrangement and also the Consideration Clause in the agreement.

The respondent-manufacturer of brake liners and brake pads in India entered into a technical assistance and trade mark agreement (TAA) with NK-foreign collaborator/licensor. Under the agreement, the licensor claimed to be in possession of certain secret processes, formula and information which it agreed to disclose it to the licensee; the licensor permitted the respondent-licensee to manufacture brake liners and brake pads-licensed products; the licensee was to import/buy raw material and capital goods from the licensor; and the licensee was to pay licence fee along with royalty, based

A on the net sales value of licensed products sold, consumed or otherwise disposed of. The Adjudicating Authority held that technical know-how fees and royalty were related to the imported goods and thus, loaded the CIF value of the imported goods with the proportionate B amount of know-how fees and royalty. The Commissioner upheld the order. However, the tribunal held that the know-how fees and the royalty payments stood related to the brake liners and brake pads to be produced in India and not to the imported goods. Hence, the present appeal.

C Dismissing the appeals, the Court

HELD: 1.1 Royalties and licence fees related to the imported goods is the cost which is incurred by the buyer in addition to the price which the buyer has to pay as D consideration for the purchase of the imported goods. In other words, in addition to the price for the imported goods the buyer incurs costs on account of royalty and licence fee which the buyer pays to the foreign supplier for using information, patent, trade mark and know-how in the manufacture of the licensed product in India. E Therefore, there are two concepts which operate simultaneously, namely, price for the imported goods and the royalties/licence fees which are also paid to the foreign supplier. (Para 18) [158-F, G]

F 1.2 Rule 9(1)(c) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 stipulates that payments made towards technical know-how must be a condition pre-requisite for the supply of imported goods by the foreign supplier and if such G condition exists then such royalties and fees have to be included in the price of the imported goods. Under rule 9(1)(c) the cost of technical know-how is included if the same is to be paid, directly or indirectly, as a condition of the sale of imported goods. If such payment has no nexus with the working of the imported goods then such payment H

was not includible in the price of the imported goods. The word indirectly in rule 9(1)(c) is emphasized. The buyer/ importer makes payment of the price of the imported goods. He also incurs the cost of technical know-how. Therefore, the Department in every case is not only required to look at TAA, it is also required to look at the pricing arrangement/agreement between the buyer and his foreign collaborator. (Paras 16 and 18) [158-D, G; 159-A, B, C]

1.3 The adjudicating authority did not examine the pricing arrangement between the foreign collaborator and the buyer. It only examined the royalty/TAA. On reading TAA, it is found that the payments of royalty/licence fees was entirely relatable to the manufacture of brake liners and brake pads-licensed products. The said payments were in no way related to the imported items. In the instant case, no effort was made by the Department to examine the pricing arrangement; to ascertain whether there exists a price adjustment between cost incurred by the buyer on account of royalty/licence fees payments and the price paid for imported items; and to ascertain enhancement of royalty/licence fees by reducing the price of the imported items. In this case, the Department has gone by TAA alone. On reading TAA in entirety, there was no nexus between royalty/licence fees payable for the know-how and the goods imported for the manufacture of licensed products. The Department itself invoked rule 9(1)(c). (Paras 19 and 20) [159-F, G; 160-A, B, C]

1.4 In the alternate, the Department invoked rule 9(1)(e). This rule 9(e) cannot stand alone. It is a corollary to rule 4. There is no finding in the instant case that what was termed as royalty/licence fee was in fact not such royalty/licence fee but some other payment made or to be made as a condition pre-requisite to the sale of the imported goods. Rule 9 refers to cost and services. Under rule 9(1), the price for the imported goods had to be

A enhanced/loaded by adding certain costs, royalties and licence fees and values mentioned in sub-rules 9(1)(a) to 9(1)(d). It refers to "all other payments actually made or to be made as a condition of sale of the imported goods." In the instant case, the Department invoked rule 9(1)(c) on
B the ground that royalty was related to the imported goods, having failed it cannot fall back upon rule 9(1)(e) because essentially the concern is with regard to the addition of royalty etc. to the price of the imported goods. Further, in the instant case, the Department accepted the transaction
C value of the imported goods. (Para 21) [160-C, D, E, F, G]

1.5 Rule 4(3)(b) of the CVR, 1988 provides for an opportunity for the importer to demonstrate that the transaction value closely approximates to a "test" value. Therefore, a number of factors have to be taken into
D consideration in determining whether one value "closely approximates" to another value. These factors include the nature of the imported goods, the nature of the industry itself, the difference in values etc. Rule 4(3)(a) and rule 4(3)(b) of the CVR, 1988 provides for different means of
E establishing the acceptability of a transaction value. The Consideration Clause in such circumstances is of relevance. Pricing arrangement and TAA are both to be seen by the Department. In a given case, if the Consideration Clause indicates that the importer/buyer
F had adjusted the price of the imported goods in guise of enhanced royalty or if the Department finds that the buyer had misled the Department by such pricing adjustments then the adjudicating authority would be justified in adding the royalty/licence fees payment to the price of the
G imported goods. Therefore, it cannot be said that the consideration clause in TAA is not relevant. Ultimately, the test of close approximation of values require all circumstances to be taken into account. Thus, there is no infirmity in the impugned order of the tribunal. (Paras 25 and 26) [161-G; 162-A, B, C, D, E, F]
H

COC v. Essar Gujarat Ltd. **1996 (88) ELT 609 (SC) – distinguished.** A

Matsushita Television & Audio India Ltd. v. CoC **2007 (211) ELT 200 (SC) – referred to.**

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 8426 of 2002 B

From the final Order No. 91/2002 dated 12/2/2002 of the Customs, Excise & Gold (Control) Appellate Tribunal, New Delhi in Appeal No. C/573/2001-A.

C

WITH

Civil Appeal Nos. 8417/03, 981/06, 3076/06, 3203/06 and 284/07.

Brijender Chahar, Abhinav Jain, Jyoti Chahar, Jagbir Singh Malik, R. Basant, Deepak Thakur and B. Krishna Prasad for the Appellant. D

V. Lakshmi Kumaran, R. Parthasarthy, Alok Yadav, M.P. Devnath, Rajesh Kumar and M/s. Dua Associates for the Respondent. E

The Judgment of the Court was delivered by

KAPADIA, J. This batch of civil appeals is filed by the Department and is directed against the orders passed by the Customs, Excise & Gold (Control) Appellate Tribunal ("CEGAT") F whereby and whereunder the appeals filed by the respondents-importers herein stood allowed. They arise from assessment proceedings and not from show cause. The adjudicating authority has held that M/s Ferodo India Pvt. Ltd. ("buyer" in short) is a subsidiary of M/s T & N International Ltd., UK and are thus G related, which finding is not in dispute.

2. For the sake of convenience we state the facts occurring in Civil Appeal No. 8426/02 –Commnr. of Customs v. M/s Ferodo India Pvt. Ltd.

H

A 3. The buyer is the manufacturer of brake liners and brake pads in India. On 8.9.1995, a technical assistance and trade mark agreement ("TAA" for short) was entered into between the respondent (buyer/licensee) and M/s T & N International Ltd., UK (foreign collaborator/licensor). Under the said agreement, B the licensor claimed to be in possession of certain secret processes, formula and information. Under the agreement, the licensor agreed to permit manufacture of brake liners and brake pads (licensed products) by the licensee. Under the agreement, the licensor agreed to disclose the relevant secret processes, C formula and information to the licensee. Under the agreement, the licensee was required to import/buy raw material and capital goods from the licensor. Under the agreement, the licensee was obliged to pay a licence fee along with royalty, based on the net sales value of licensed products sold, consumed or otherwise D disposed of.

4. Vide order dated 22.9.1999 the adjudicating authority held that, technical know-how fees and royalty were related to the imported goods and were a condition of sale for the import thereof and consequently, the adjudicating authority loaded the E CIF value of the imported goods with the proportionate amount of know-how fees and royalty. In this connection, reliance was placed on the judgment of this Court in **CoC** v. **Essar Gujarat Ltd.** reported in 1996 (88) ELT 609 (SC). This order was confirmed by the Commissioner (A). However, by the impugned F order dated 12.2.2002, the Tribunal held that the know-how fees and the royalty payments stood related to the brake liners and brake pads to be produced in India and not to the imported goods. Hence, this civil appeal by the Department.

5. In this case, we are required to lay down the scope of G rule 9(1)(c) and rule 9(1)(e) of CVR, 1988, which are quoted hereinbelow:

"**9. Cost and services.-**

(1) In determining the transaction value, there shall be H added to the price actually paid or payable for the imported

goods,-

(a) ...

(b) ...

(c) Royalties and licence fees related to the imported goods that the buyer is required to pay, directly or indirectly, as a condition of the sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid or payable.

(d) ...

(e) All other payments actually made or to be made as a condition of sale of the imported goods, by the buyer to the seller, or by the buyer to a third party to satisfy an obligation of the seller to the extent that such payments are not included in the price actually paid or payable."

6. At the outset, it may be stated that, this is not the case of rejection of transaction value, though it is held to be a related party transaction. In this matter we are concerned with adjustment/addition to the price of the imported goods under rule 9(1)(c) or in the alternative under rule 9(1)(e).

7. Under Section 14 of the Customs Act, 1962, the assessable value of imported goods is deemed to be the price at which such or like goods are ordinarily sold or offered for sale for delivery at the time and place of importation or exportation, as the case may be, in the course of international trade, where the seller and the buyer have no interest in the business of each other and the price is the sole consideration for the sale or offer of sale.

8. The Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 ("CVR, 1988" for short) recognises the fundamental principle of arm's length price while dealing with transaction value. The Rules provide for the

A determination of the correct price of goods that are imported in the country or exported out of the country uninfluenced by relationship between the transacting parties.

9. Transaction Value, Deductive Value, Computed Value and Residual Value Methods are the methods prescribed in B the Rules, to be followed sequentially in that order in the matter of determination of arm's length pricing.

10. To determine the assessable value for the levy of customs duty on imported goods, Section 14 of the 1962 Act C has to be read with the provisions of CVR, 1988 because under Section 14(1) there is reference to a **deemed price of goods imported** and under Section 14(1A) such deemed price is to be determined in accordance with the CVR, 1988.

11. Rule 3 of the CVR, 1988 *inter alia* provides for six D methods of determination of the price of imported goods. The six methods are:

Method 1 – Transaction Value (Rule 4)

The primary basis for customs duty is "transaction value", E as defined in rule 4(1) of CVR, 1988, which is the price actually paid or payable for the goods when sold for export to India, adjusted in accordance with the provisions of rule 9. Adjustments to the price actually paid or payable are required in cases where certain specific elements which F form part of the value for customs purposes are incurred by the buyer but are not included in the price actually paid or payable for the imported goods. Rule 9 embodies the principle of attribution of certain costs to the price of the imported goods. Rule 9 also provides for inclusion of certain considerations which passes from the buyer to the G supplier in the form of specified goods or services, other than in the form of money.

Method 2 – TV of Identical Goods (Rule 5)

Rule 5 through rule 7A provides for four alternate methods H

of determining the customs value whenever such value cannot be decided under the provisions of rule 4.

Under Rule 5, the value of imported goods shall be the transactional value of identical goods sold for export to India if the goods are:

(i) the same in all respects (including physical characteristics, quality and reputation);

(ii) produced in the same country as the goods being valued; and

(iii) produced by the producer of the goods being valued.

Method 3– TV of Similar Goods (Rule 6):

Under this method, the value of imported goods is the transaction value of similar goods if:

(i) goods closely resemble the goods being valued in terms of components, materials and characteristics;

(ii) goods which are capable of performing the same functions and are commercially interchangeable with the goods being valued;

(iii) goods which are produced in the same country and by the producer of the goods being valued.

Rule 6A provides for determination of value when transaction value cannot be determined under rules 4, 5 and 6. In such cases, the following two methods are envisaged on the request of the importer and subject to the approval of the proper officer, i.e., under rules 7 and 7A.

Method 4 – Deductive Value (Rule 7)

Rule 7 provides that when customs value cannot be determined on the basis of transaction value of the imported goods or identical or similar goods, the value of

A the imported goods shall be based on the unit price at which the imported goods or identical goods or similar goods are sold to an unrelated buyer in the country of importation in the greatest aggregate quantity.

B The starting point in calculating the deductive value is the same price in the country of importation. Various deductions are necessary to reduce that price to the relevant customs value. These deductions are:

(i) commissions usually paid or agreed to be paid, C profits and general expenses added in connection with sales;

(ii) usual transport cost and corresponding insurance are to be deducted from the price of the goods when these costs are usually incurred within the country of D importation;

(iii) the customs duty and other national taxes payable in the country of importation by reason of importation;

(iv) value added by further processing, wherever E applicable.

Method 5 – Computed Value (Rule 7A)

Computed value determines the customs value on the basis of the cost of production of the goods being valued F plus an amount for profit and general expenses usually reflected in sales from the country of exportation to the country of importation of goods of the same class or kind. It is, therefore, the total sum of production cost and profit and general expenses.

G **Method 6 – Fall-Back Method (Rule 8)**

When the customs value cannot be determined under any of the previous methods, it has to be determined using reasonable means consistent with the principles and H general provisions of the CVR, 1988 and Section 14(1) of

the 1962 Act and on the basis of data available in India. To the great extent possible, this method is based on previously determined values and methods with a reasonable degree of flexibility in their application.

Basis of CVR, 1988

12. Article 7 of GATT, 1994 is the foundation of the CVR, 1988. The said Article brought in the concept of arm's length price in customs valuation to test values arrived from sale of identical or similar goods and in cases where such values were not available, it provided for deductive and computed value methods, which methods are akin to resale price method and cost plus method under the transfer pricing in the Income-tax Act, 1961.

Role of Interpretative Notes to CVR, 1988

13. At the outset, it may be stated that rule 9(1)(c) has to be read with the Interpretative Notes and when so read it authorises the Customs to add the royalties/licence fees to the assessable value only in certain conditions, namely, when the royalties/licence fees are related to imported goods; that, when the buyer is required to pay to the seller, directly or indirectly, as the condition of the sale of the goods being valued, such royalties and licence fees are not included in the transaction value.

14. One more significance of the Interpretative Notes is that it has placed the burden on the importer/buyer to prove the correctness of the price of the imported goods in terms of the **means** prescribed in rule 4(3)(a) and rule 4(3)(b). In other words, the CVR mandates the hierarchy of valuation methods to be applied in the event of the transfer price being rejected.

Analysis of Rule 9(1)(c)

15. Rule 9(1)(c) extends the quantum of levy under rule 4. Rule 9(4) mandates that there can be addition to the transaction value except as provided in rule 9(1) and (2). Hence, addition for cost can only be made in situations coming under rule 9(1)

A and (2). Rule 9(1) and (2) is based on the principle of attribution. Under Customs law, valuation is done on pricing whereas in the case of transfer pricing under Income-tax Act, 1961, valuation is profit based. The principle of attribution of certain costs (including royalty and licence fee payments) to the price of the B imported goods is provided for in rule 9 under situations mentioned in rule 9(1) and (2). In transfer pricing, the arm's length price is inferred from various methods to avoid profit-shift from one jurisdiction to another and it is here that principle of allocation of profits comes in (i.e. in the case of transfer C pricing).

16. Under rule 9(1)(c), the cost of technical know-how and payment of royalty is includible in the price of the imported goods if the said payment constitutes a **condition pre-requisite for the supply of the imported goods by the foreign supplier**. D If such a condition exists then the payment made towards technical know-how and royalties has to be included in the price of the imported goods. On the other hand, if such payment has no nexus with the working of the imported goods then such payment was not includible in the price of the imported goods.

E 17. In the case of **Essar Gujarat Ltd.** (supra) the condition pre-requisite, referred to above, had direct nexus with the functioning of the imported plant and, therefore, it had to be loaded to the price thereof.

F 18. Royalties and licence fees related to the imported goods is the cost which is incurred by the buyer in addition to the price which the buyer has to pay as consideration for the purchase of the imported goods. In other words, in addition to the price for the imported goods the buyer incurs costs on G account of royalty and licence fee which the buyer pays to the foreign supplier for using information, patent, trade mark and know-how in the manufacture of the licensed product in India. Therefore, there are two concepts which operate simultaneously, namely, price for the imported goods and the royalties/licence fees which are also paid to the foreign supplier. Rule 9(1)(c) H

stipulates that payments made towards technical know-how must be a condition pre-requisite for the supply of imported goods by the foreign supplier and if such condition exists then such royalties and fees have to be included in the price of the imported goods. Under rule 9(1)(c) the cost of technical know-how is included if the same is to be paid, directly or indirectly, as a condition of the sale of imported goods. At this stage, we would like to emphasis the word *indirectly* in rule 9(1)(c). As stated above, the buyer/importer makes payment of the price of the imported goods. He also incurs the cost of technical know-how. Therefore, the Department in every case is not only required to look at TAA, it is also required to look at the pricing arrangement/agreement between the buyer and his foreign collaborator. For example if on examination of the pricing arrangement in juxtaposition with the TAA, the Department finds that the importer/buyer has misled the Department by adjusting the price of the imported item in guise of increased royalty/ licence fees then the adjudicating authority would be right in including the cost of royalty/licence fees payment in the price of the imported goods. In such cases the principle of attribution of royalty/licence fees to the price of imported goods would apply. This is because every importer/buyer is obliged to pay not only the price for the imported goods but he also incurs the cost of technical know-how which is paid to the foreign supplier. Therefore, such adjustments would certainly attract rule 9(1))(c).

Application of Rule 9(1)(c) to the facts of the present case

19. Applying the above tests to the facts of the present case, we find that the adjudicating authority had not examined the pricing arrangement between the foreign collaborator and the buyer. It has only examined the royalty/TAA.

20. Be that as it may, in the present case, on reading TAA we find that the payments of royalty/licence fees was entirely relatable to the manufacture of brake liners and brake pads (licensed products). The said payments were in no way related

A to the imported items. In the present case, no effort was made by the Department to examine the pricing arrangement. No effort was made by the Department to ascertain whether there exists a price adjustment between cost incurred by the buyer on account of royalty/licence fees payments and the price paid for B imported items. No effort was made by the Department to ascertain enhancement of royalty/licence fees by reducing the price of the imported items. In the circumstances, we find no infirmity in the impugned judgment of the Tribunal. In this case, the Department has gone by TAA alone. On reading TAA in C entirety, we are of the view that there was no nexus between royalty/licence fees payable for the know-how and the goods imported for the manufacture of licensed products. The Department itself has invoked rule 9(1)(c).

21. In the alternate, it has invoked rule 9(1)(e). This rule D 9(e) cannot stand alone. It is a corollary to rule 4. There is no finding in the present case that what was termed as royalty/ licence fee was in fact not such royalty/licence fee but some other payment made or to be made as a condition pre-requisite to the sale of the imported goods. It is important to bear in mind E that rule 9 refers to cost and services. Under rule 9(1), the price for the imported goods had to be enhanced/loaded by adding certain costs, royalties and licence fees and values mentioned in sub-rules 9(1)(a) to 9(1)(d). It refers to "all other payments actually made or to be made as a condition of sale of the F imported goods." In the present case, the Department invoked rule 9(1)(c) on the ground that royalty was related to the imported goods, having failed it cannot fall back upon rule 9(1)(e) because essentially we are concerned with the addition of royalty etc. to the price of the imported goods. Further, in the present case, G the Department has accepted the transaction value of the imported goods.

22. In the case of **Essar Gujarat Ltd.** (supra), the buyer had entered into a contract with TIL for purchase of Direct Reduction Iron Plant ("the plant"). The entire agreement was for H import of the plant. The agreement was subject to two conditions-

(a) approval of G.O.I. and (b) obtaining transfer of licence from M/s Midrex, USA. Without the licence from Midrex, the imported plant was of no use to the buyer. Therefore, it was essential to have the licence from Midrex to operate the plant. Therefore, it was held by this Court that procurement of licence from Midrex was a pre-condition of sale *which was specifically recorded in the agreement itself.* In view of specific terms and conditions to that effect in the agreement, this Court held that payments made to Midrex by way of licence fees had to be added to the price paid to TIL for purchase of the plant. There is no such stipulations in the TAA in the present case. Therefore, in our view, the adjudicating authority erred in placing reliance on the judgment of this Court in **Essar Gujarat Ltd.** (supra).

23. In the case of **Matsushita Television & Audio India Ltd. v. CoC** reported in 2007 (211) ELT 200 (SC) the question which arose for determination was whether royalty amount was attributable to the price of the imported goods. In that case, the appellant was a joint venture company of MEI, Japan and SIL for obtaining technical assistance and know-how. Under the agreement, the appellants were to pay MEI a royalty @ 3% on net ex-factory sale price of the colour TV receivers manufactured by the appellants for the technical assistance rendered by MEI. The appellants were to pay a lump-sum amount of U.S. $ 2 lakhs to MEI for transfer of technical know-how. It was the case of the appellant that payment of royalty was not related to imported goods as the said payment was made for supply of technical assistance and not as a condition pre-requisite for the sale of the components.

24. One of the questions which arises for determination in this civil appeal is whether reliance could be placed by the Department only on the Consideration Clause in the TAA for arriving at the conclusion that payment for royalty was includible in the price of the imported components.

25. Rule 4(3)(b) of the CVR, 1988 provides for an opportunity for the importer to demonstrate that the transaction

A value closely approximates to a "test" value. A number of factors, therefore, have to be taken into consideration in determining whether one value "closely approximates" to another value. These factors include the nature of the imported goods, the nature of the industry itself, *the difference in values* etc.. As
B stated above, rule 4(3)(a) and rule 4(3)(b) of the CVR, 1988 provides for different *means* of establishing the acceptability of a transaction value. In the case of **Matsushita Television** (supra) the pricing arrangement was not produced before the Department. In our view, the Consideration Clause in such
C circumstances is of relevance. As stated above, pricing arrangement and TAA are both to be seen by the Department. As stated above, in a given case, if the Consideration Clause indicates that the importer/buyer had adjusted the price of the imported goods in guise of enhanced royalty or if the Department
D finds that the buyer had misled the Department by such pricing adjustments then the adjudicating authority would be justified in adding the royalty/licence fees payment to the price of the imported goods. Therefore, it cannot be said that the consideration clause in TAA is not relevant. Ultimately, the test of close approximation of values require all circumstances to
E be taken into account. It is keeping in mind the Consideration Clause along with other surrounding circumstances that the Tribunal in the case of **Matsushita Television** (supra) had taken the view that royalty payment had to be added to the price of the imported goods.

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26. For the aforestated reasons, we find no infirmity in the impugned orders of the Tribunals. Accordingly, the civil appeals filed by the Department are hereby dismissed with no order as to costs.

G N.J. Appeals dismissed.