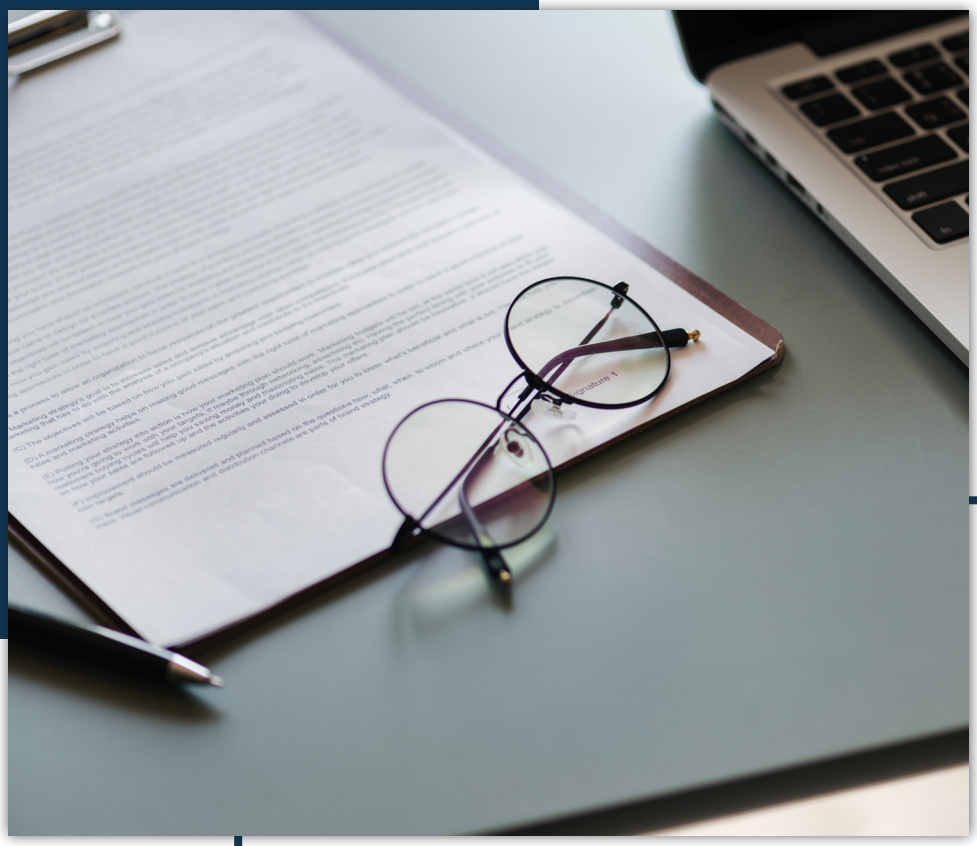

Royalty and license fees for customs valuation – ‘To include or not to include?

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Modern day customs duty is the developed version of an ancient 'custom' to levy duty on goods brought from outside kingdoms. This makes custom duty one of the most ancient levies of the world. As on date, several nations, including India, are members of the World Customs Organization ('WCO') and signatories to various customs conventions. Despite the law being regulated at an international level, India continues to be involved in litigations on several critical aspects.

One such basic question is the inclusion of royalty or license fees in the value of imported goods. Royalty or license fee, for technology and know-how related to manufacture of goods, has been the most recurring payment / transaction entered between Indian companies and their foreign counterparts since the economic reforms passed in 1991. However, till date there are several disputes revolving around the inclusion of same in value of parts imported from related party or other parties.

Section 14 of the Customs Act, 1962 ('Customs Act') read with Rule 10 of the Customs Valuation (Determination of Price of Imported Goods) Rules, 2007 ('Valuation Rules') provides for inclusion of certain costs and fees when incurred by the buyer. The provision ensures that all hidden costs relating to the imported goods are added while computing the value of such goods, and importer does not reduce the cost of imported goods by artificially increasing the value of other service components. Royalties and license fees are also added within the value of imported goods, provided they are related to the imported goods and are paid as a condition of sale of goods being valued.

Thus, there are two important aspects which needs to be cumulatively satisfied in order for royalty payment to be included in the value of imported goods; viz.

(i) Payment of royalty and license fees relates to the imported goods; and
(ii) Payment is made as a condition of sale of goods.

These dual conditions have also been stressed by Saul L. Sherman in his celebrated work, 'Customs Valuation- Commentary on the GATT Customs Valuation Code' ('Commentary by Sherman'). To further the complexity, the Explanation to Rule 10 provides that where royalty payment is made on a process, the charges would be added to the value of imported goods even where the goods are subjected to such process after importation.

Given the pertinence of both the aspects, the author wishes to discuss the two aforesaid conditions separately –

Payment relates to imported goods:

The said condition demands that royalty or license fees being paid must mandatorily relate to the imported goods. The determination of same rests solely on the individual arrangement entered by two persons. Notably, where the royalty being paid is for technical know -how for manufacture of a product which may or may not require import of goods from the same party, then the royalty doesn't relate to imported goods. Alternatively, if the imported goods are the only item of value being transferred from the exporter to the Indian importer under the parts purchase agreement, then it would suggest imported

goods being independent transaction from technical know how and royalty payment .

Thus, it is important to gauze whether there is involvement of any independent service for which importer is paying royalty, or the royalty amount is integrally related to purchase of goods.

Payment being made as a condition of sale of goods:

The second condition requires that the royalty payment must be made as a condition of sale of imported goods. Pertinently, royalty will become a condition to sale of imported goods only if in the absence of such payment, the goods wouldn't have been exported to India at all or the value at which such goods have been offered would have altered.

Like the earlier condition, the determination of this condition also rests in the careful assessment of the arrangement of the exporter and Indian importer. One of the important determining factors is cross-linkage of parts purchase agreement and royalty agreement, or single agreement mandating both the procurements. The moot question to determine is if the royalty payment can be said to be independent from the purchase of goods, or both are inter-dependent.

The said provision has been interpreted by the Indian Courts on several occasions wherein the Courts have deliberated on the inclusion of royalty payments in the value of imported goods. A case which requires a special mention here is **Matsushita Television and Audio (I) Ltd. v CC**[1] , wherein the Supreme Court included the royalty payment made by the appellant in the value of imported goods. The moot observation of the Court was that since the royalty was payable at 3 percent of the net ex-factory sales price of the manufactured product (which included price of the imported components), royalty will be considered as a condition of sale.

In the said case, the Supreme Court failed to draw a proper nexus between the royalty payment being made and the imported goods and relied solely on the definition of 'net ex-factory sales price' under the agreement. In author's considered view, the said ruling is incorrect as it fails to cumulatively satisfy the two pillars of royalty inclusion discussed above.

Further, in **CC v Ferodo India Pvt. Ltd.**[2] , the Supreme Court assessed a similar arrangement wherein which royalty was being paid by the importer on the subsequent manufactured product. The Supreme Court deliberated on the pricing arrangement of the parties and the trademark agreement in its entirety and held that the royalty payment had no nexus with the goods being imported. Resultantly, such royalty wasn't added to the value of imported goods.

What is to be seen in the said two cases is how the same provision has been differently applied in similar circumstances. Notably, **none of the two cases have been reversed/ distinguished at the Apex court level**. Thus, there exists a dilemma in the inclusion of royalty payment made for manufacture of a distinct product which may comprise the imported components.

As on date, SVB orders are not being periodically reviewed due to automatic renewal process post 2016. However, the importers still need to be mindful that the department may decide to review the SVB order at any point in time. In such cases, the department might rely on Matsushita as it is more favorable to their stance. Thus, despite the existing dilemma which occurs due to contrary Supreme Court rulings, it is recommended that the importers structure their agreements in an unambiguous manner to avoid any future complexities.

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[1] 2007 (211) ELT 200 (SC)
[2] 2008 (224) ELT 23 (SC)

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