

EY Tax Alert

CESTAT holds royalty paid by OEM to overseas entities is includible in the assessable value of goods imported by contract manufacturer

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Executive summary

This Tax Alert summarizes the recent ruling¹ of the Customs, Excise and Service Tax Appellate Tribunal, Chennai (CESTAT) on whether the royalties paid by original equipment manufacturer (OEM) to overseas entities should be added to the assessable value of the goods imported by Contract Manufacturers (CMs).

The assessee and its group entities entered into an agreement with CMs to manufacture mobile phones to be sold to the assessee. CMs imported parts and components from overseas group entities for this purpose. Assessee paid royalty and license fees to overseas entities on further sale of such manufactured mobile phones.

The key observations of the CESTAT are:

- ▶ CMs did not enjoy unfettered rights of possession of the imported goods. Given the agreement's conditions, restrictions, and reimbursement terms, the assessee is effectively the real buyer. The agreement's core purpose is not the sale of parts but provision of work and labor.
- ▶ Since the CMs do not obtain effective possession or control over the goods, the assessee is the beneficial owner of the goods.
- ▶ Ownership of goods is not an essential condition to be an importer. Section 2(26) of the Customs Act, 1962 defines an "importer" to include the owner, beneficial owner, or any person presenting himself as the importer. On purposive reading of the above definition along with Section 28(4), duty can be demanded from the beneficial owner *i.e.*, the assessee in the present case.
- ▶ The agreement shows that royalty is paid for bundled software and hardware technologies embedded in the imported components, and commercial structuring does not change the fact that the royalty directly relates to those imported parts.

Accordingly, the CESTAT held that the royalty/license fee paid by assessee should be added to the assessable value of the goods imported by CMs as per Section 14 of the Customs Act. Consequently, it upheld the demand on the assessee even for the extended period of limitation along with interest and penalty.

¹ TS-733-CESTAT-2025-CUST



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Background

- ▶ In terms of Section 2(26) of the Customs Act, 1962, importer, in relation to any goods at any time between their importation and the time when they are cleared for home consumption, includes any owner, beneficial owner or any person holding himself out to be the importer.

- ▶ The term beneficial owner is defined under Section 2(3A) as any person on whose behalf the goods are being imported or exported or who exercises effective control over the goods being imported or exported.

- ▶ Section 14(1) provides that value of the imported goods and exported goods shall be the transaction value of such goods.

However, proviso to Section 14(1) provides that such transaction value in the case of imported goods shall include, in addition to the price payable, any amount paid or payable for costs and services, including royalties and license fees to the extent and in the manner provided in Custom Valuation rules.

- ▶ As per Rule 10(1)(c), of the Customs Valuation (Determination of value of Imported Goods) Rules, 2007, royalties and license fees related to the imported goods that the buyer is required to pay, directly or indirectly as a condition of sale of goods being valued, shall be added to the transaction value.

Explanation to the above rule provides that royalty charges for a process shall be added to the value of imported goods notwithstanding the fact that such goods may be subjected to the said process after importation of goods.

Notes to the said rules further state that the royalty payment referred to in Rule 10(1)(c) shall not be included if it is not a condition of sale.

- ▶ Assessee, in the present case is engaged in the business of selling consumer electronic goods. It either import goods such as mobile phones, televisions, etc., from its overseas group entities or gets it manufactured from Contract Manufacturers (CMs) in India.
- ▶ The CMs manufacture mobile phones using parts and components imported from various group entities of the assessee.
- ▶ Based on intelligence gathered by the Directorate of Revenue Intelligence, it appeared that the assessee had paid royalty and license fees under agreements with overseas parties, but these payments were not disclosed to the Customs Department.
- ▶ A show cause notice (SCN) was issued to the assessee and the CMs and the assessable value of

the mobile phones was re-determined, differential customs duty was demanded, and the goods were held liable for confiscation along with penalties.

- ▶ Aggrieved, assessee filed appeal before the Appellate Tribunal.

Assessee's Contentions

- ▶ The parts and components were imported by third-party contract manufacturers on their own account for manufacturing mobile phones. Since the assessee had no control over these components, they should not be regarded as the beneficial owner.
- ▶ Once a person is declared and accepted as the importer between importation and clearance, no other person can be treated as the importer after clearance.
- ▶ The concept of 'beneficial owner' was introduced as an anti-avoidance measure against the practice of IEC lending and thus, not applicable to the present scenario. When the owner of goods is available, the concept of beneficial owner is not applicable².
- ▶ SC in case of Vellanki Frame Works³ observed that the definition of importer cannot be used to usurp the identity of an importer from the person who filed the bill of entry.
- ▶ The demand under Section 28 of the Customs Act can only be raised on the importer who filed the bill of entry, and it cannot be demanded from any other person.
- ▶ Royalty cannot be added to the assessable value of components imported by third-party manufacturers as it has been paid by the assessee and not by the CMs being the buyers of the imported goods.
- ▶ Even assuming that assessee itself imports the components, the royalty paid is for grant of license of standard essential patents and not related to imported goods. Further, they are not related to any specific model of mobile phone or any specific imported component.
- ▶ The royalty agreement and the purchase agreement are independent of each other and neither requires the payment of royalty as a condition of sale of imported components.
- ▶ Payment of royalty is for the post-import activity and is not related to the import of components or mobile phones.
- ▶ Mere fact that imported components could have not served any purpose without payment of royalty cannot be the reason for addition of royalty to the value of components.

² CESTAT, New Delhi, FINAL ORDER NO. 50283/2022, Dated: 28.03.2022

³ 2021 (375) ELT 289 (S.C.)

Revenue's Contentions

- ▶ CMs operate under contractual agreements with both assessee and overseas entity, which stipulate that assembled mobile phones are to be sold exclusively to assessee.
- ▶ CMs are not involved in price negotiation for purchase of components. They have no control over the finalization or fixation of price.
- ▶ If CMs fail to remit the invoice value of imported goods, assessee has the right to hold the payment towards sale of finished mobile phones.
- ▶ All indirect taxes, fines, penalties, deposits made by CMs including legal fees paid on account of valuation of imported goods are reimbursed by assessee.
- ▶ Since the imported parts and components are used to manufacture mobile phones which are ultimately sold by assessee, the imports are effectively on assessee's behalf, making it the "beneficial owner" under Section 2(26) of the Customs Act.
- ▶ The payment of license fee/royalties was required to operate the entire business of import and sale. The payments were made as a condition of sale and were related to the imported goods.
- ▶ The imported components are meant solely for manufacturing mobile phones, and the intellectual property rights (IPRs) are essential for this process. Without these rights, importing the parts and components serves no purpose for either the contract manufacturers or the brand owner.
- ▶ Accordingly, royalty is includible in the transaction value as per Section 14, read with Rules 10(1)(c) and 10(1)(e) along with the explanation contained therein.

Tribunal ruling

Whether the CMs are the importers of the parts and components?

- ▶ Various courts have held that the nomenclature of any contract or document is not decisive of its nature. When contrivance or camouflage is adopted, the Courts must determine the true intention by examining the agreement's genesis, context, and surrounding circumstances⁴.

Assessee grants CMs a non-exclusive royalty-free license to use IPR which is either owned or licensed to them solely for the CMs production of goods and not for any other purpose.

Assessee purchases finished mobile phones from CMs under a cost-based pricing model, leaving CMs no discretion in setting prices. Thus, excluding the

royalty/license fee from the price structure can reasonably be presumed to be at assessee's behest as it being the dominant party.

Accordingly, it can be said that the CMs did not enjoy unfettered rights of possession of the imported goods. Although the goods were in their physical possession upon import, effective control remained with the Indian and overseas entities.

- ▶ Ownership of goods includes rights such as possession, use, enjoyment, consumption, destruction, and transfer. A 'sale' involves transferring these ownership rights from the seller to the buyer resulting in the buyer acquiring, and the seller losing those rights.

SC in case of BSNL Vs UOI⁵ held that 'use of goods' comes with a lesser bundle of rights than the 'ownership of goods'. If a seller retains control or other ownership rights over the goods, the transaction cannot be considered a genuine sale.

It must be shown beyond the agreement that the seller actually transfers possession and effective control of the components to the CMs, and that the arrangement is not merely a license to use goods or a service contract disguised as a sale.

The present arrangement does not make CMs the owner of goods. The manufacture of finished mobile phones by the CMs was subject to conditions, restrictions and obligations which did not allow the CMs to have effective control over the imported parts and components.

- ▶ SC in case of Gannon Dunkerely & Co. (Madras) Ltd⁶ held that to constitute a transaction of sale there should be an agreement, express or implied, relating to goods to be completed by passing of title in those goods.

A person cannot pass on a better title to goods than he himself has. When the CMs do not obtain effective title to the parts and components, they cannot then transfer that title to assessee by sale.

The law presumes that a businessman arranges his affairs in his best interest and does not absorb costs that are not his, such costs ultimately rest with the true owner. Even if agreements place the initial burden on another party, no businessman will bear costs it does not need.

Given the conditions, restrictions, obligations, and reimbursements in the agreements, a prudent person would conclude that the assessee and not the CM is the real buyer of the imported goods.

The main object of the agreement is not for sale by the transfer of the property in the parts and components, but it is one for work and labor.

⁴ (1977) 1 SCC 1; (1996) 9 SCC 388; 1981, Vol-9, para 2461

⁵ [(2006) 145 STC 91 (SC)]

⁶ 1958 (04) TMI 42

Whether assessee is the beneficial owner of the imported parts and components?

- ▶ The Black's Law Dictionary defines beneficial ownership as a legal term where specific property rights ("use and title") in equity belong to a person even though legal title of the property belongs to another person.

Under the Customs Act, the definition of importer is not tied down to the concept of owner of the goods but also includes beneficial owner.

Identifying beneficial owner requires examining how a person exerts control directly or through legal structures without being the owner on paper. Possession and ownership may differ, but the minimum requirement is custody or control over the goods.

- ▶ The terms of the agreement show that the rights of the CMs are very restricted and most of the terms are averse to them.

Substantial control is with assessee who is the dominant party in the agreement and there is no right of effective possession and control that comes to vest with the CMs. Accordingly, assessee is the beneficial owner of goods.

Can the duty be demanded from the beneficial owner?

- ▶ The amendment to the definition of 'importer' is being designed to prevent tax evasion and tax base erosion. Thus, the term cannot be used in a restricted sense so as to defeat the avowed object of the Legislation⁷.
- ▶ Ownership of goods is not an essential condition to be an importer. Since Section 2(26) of the Customs Act, defines an "importer" to include the owner, beneficial owner, or any person presenting himself as the importer, the issue arises as to who should bear the tax.
- ▶ Section 28 of the Act deals with the recovery of duties not levied or not paid or short-levied or short-paid or erroneously refunded.

Ordinarily the goods can be imported by a consignee of the goods who is either its owner or beneficial owner or any person holding himself out to be the importer, and not by more than one person simultaneously.

Under Section 28(4), where duty is demanded due to blameworthy conduct by the importer, exporter, or their agent or employee, a notice must be issued to the person chargeable with duty or interest.

The Customs Act, in special circumstances, allows the Proper Officer to examine the actual person who is the importer and as per Section 28(4) permits him to serve notice on the person chargeable with duty or interest.

- ▶ The sub-section must be interpreted in a way that addresses the mischief the term "beneficial owner" was intended to prevent, keeping in view the term's evolution in India and the rapid global rise of such white-collar offences.

A purposive interpretation of the term beneficial owner along with section 28(4) provides that duty can be demanded from the beneficial owners.

Whether the payment of royalty can be added to the transaction value of the imported goods under Rule 10(1)(c)

- ▶ Interpretation of erstwhile Rule 9 and present Rule 10 of the Valuation Rules provides that there are two concepts which operate simultaneously, namely, price for the imported goods and the royalties/license fees which are also paid to the foreign parties.

Importers must pay both the price of the goods and the cost of technical know-how supplied by the foreign party. It must be assessed whether the imported goods have any value or utility without the seller's license.

- ▶ When payment to the seller is a percentage of the sales turnover of the finished product including the value of imported components, it becomes a condition of sale. If the payment has no nexus with the imported goods, it is not includible in their transaction value.
- ▶ A review of the agreement shows that royalty is paid for bundled licensed software and hardware technologies embedded in the imported parts and components used in manufacturing and selling the finished mobile phones.
- ▶ When a whole portfolio or whole-device royalty is paid under an agreement that factors in the cost of imported parts and components, a rebuttable presumption arises that the royalty relates to the imported goods.

Therefore, it is for the assessee to provide an item-wise, stage-wise royalty breakdown to show what portion, if any, should be added to the transaction value of each imported item.

- ▶ Royalty paid exclusively for manufacturing IPR's/patents whether belonging to software or hardware technologies relate to a post import activity.

However, if royalty relates to embedded IPRs or patents that are essential for the imported parts to function and cannot be separated from other post-import technologies, then the full royalty must be included in the transaction value.

- ▶ Structuring arrangements to suit commercial practice or convenience does not change the fact

⁷ 2011 (269) E.L.T. 257 (Tri-LB)

that the royalties are paid for technologies that include the imported parts and components.

- ▶ The contention of the assessee that demand of customs duty on account of inclusion will not sustain on the ground that the royalty is payable only at the time of sale of the finished phones in India and is not a condition of sale of imported components, is not correct.

The subject of tax is different from the measure on which / the stage at which royalty is determined and paid by parties to an agreement. The point of payment of royalty is not determinative of the payment being a post import payment.

- ▶ Royalty payments are directly tied to the imports, and without paying them, the assessee cannot sell the phones. The payment, thus, has nexus with the imported goods, and includible in the transaction value of such goods.

Extended period of limitation, confiscation and penalty

- ▶ The assessee has deliberately indulged in suppression of facts by way of willful misstatement and mis-declaration leading to the short levy of duty at the time of import and, hence, the demand for duty under the extended period is justified.
- ▶ No interest or penalty or fine can be imposed on the assessee insofar it relates to demand for differential IGST portions as no penalty or interest is leviable in the absence of machinery provision.
- ▶ The complex ownership structures and contractual arrangements were used intentionally to avoid tax liabilities. Their claims of confusion due to the interpretative nature of the law are unconvincing, as willful suppression of facts was established.

Accordingly, the goods are subject to confiscation under Section 111(m) of the Act and those involved are liable for penalty under Section 114A.

It is not a case where any declaration, statement or document which is false or incorrect in any material particular, has been alleged in the SCN. Hence a penalty under section 114AA will not be applicable.

However, CMs knowingly made false declaration relating to the transaction value in the bill of entries filed by them, by not adding the amount of royalty. Hence, they are liable for a penalty under Section 114AA along with penalty under Section 112(a) of the Customs Act.

Comments

- CESTAT ruling may significantly impact various sectors operating under the similar commercial arrangement involving contract manufacturing and technology transfer.
- Applicability of this ruling regarding “condition of sale” may have to be analysed in cases where businesses can segregate royalty payments related to imported components from the one associated with post-import manufacturing or distribution activities.
- The order passed by CESTAT is likely to be appealed before the Supreme Court.

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