Supreme Court: Royalty paid by distributor not includable in the assessable value of CDs replicated by job worker

Tax Alert
May 20, 2015

M/s KRCD (I) Pvt Ltd vs. Commissioner of Central Excise, Mumbai[1]

The Hon'ble Supreme Court has held that for the purpose of Central Excise duty, royalty charges payable by distributors/ copyright owners to artists/ production houses were not includable in the assessable value of Compact Discs (CDs) which have been replicated by job workers on the basis of master CDs supplied to them.

FACTS

1. The appellant, a job-worker, manufactured replicated CDs from a master tape/CD issued to them by a distributor who had copyrights in the contents of the CD. The following chain depicted how the transaction of job work was done: the artist/lyricist who was the owner of copyright parted with the copyright for a certain consideration to a producer of music, the music/picture was then captured on the video CD and CD. The producer in turn, parted with such copyright in favour of a distributor, who ultimately, got the said CDs duplicated by the appellant (job-worker). The distributor then sold the CDs in the market to the ultimate customer.

2. The appellant/job-worker was only given the master CD from which it duplicated such master tape/CD on blank CDs that were owned by it (the job-worker) and then sold to the distributor. The distributor then, upon receipt of the copies from the appellant, loaded (proportionately) part of the royalty paid to the music producer on each such CD, which was then sold to the ultimate customer in the market. The entire stock of duplicate CDs manufactured by job-worker could only be sold to the distributor/copyright holder and to nobody else.

3. The appellant had apart from the cost of raw material and other expenses, included royalty of one rupee per CD in the assessable value of the CD on account of music content in the CD.

4. For the CDs cleared during the period November, 2000 to October, 2001, the Tax Department confirmed demand for differential excise duty on account of royalty payable to the distributor/ copyright which royalty was calculated at Rs. 54.81 rupees per CD.

5. In appeal, the Commissioner (Appeals) held that royalty charges incurred by the distributor/ copyright holder was liable to be included in the assessable value of the CDs and accordingly remanded the case to the Assistant Commissioner to quantify the demand, after taking into consideration the amount of royalty to be apportioned, in terms of the methodology prescribed under Circular No. 619/10/2002-CX dated 19.02.2002 ("Circular of 2002").

6. The Customs, Excise and Service Tax Appellate Tribunal ("CESTAT") confirmed the order of the Commissioner (Appeals). The order passed by the CESTAT was the subject matter of appeal before the Hon'ble Supreme Court.

JUDGEMENT

The Special Tax Bench of the Hon'ble Supreme Court while holding in favour of the appellant (job-worker), held that the royalty payable by the distributor/copyright holder was not includable in the assessable value of the replicated CDs as manufactured by the job-worker. In this regard the Hon'ble Supreme Court inter alia observed:

1. In the present facts, Section 4(1)(a) of the Central Excise Act, 1944 ("CEA") would not apply since price was not the sole consideration for the sale, as a master tape had to be handed over by the distributor/copyright holder to the appellant. Since Section 4(1)(b) of the CEA applied, the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 ("Valuation Rules"), would apply. Both sides agreed that Rule 6 of the Valuation Rules applied to the present facts.

2. On an examination of clause (iv) of Explanation to Rule 6 of the Valuation Rules[2] (in *pari materia* with the present clause (iv) of Explanation 1 of the Valuation Rules), the Hon'ble Supreme Court observed that where the master tape was supplied by the distributor/ copyright holder to the appellant, whether free of cost or at a reduced cost, such master tape must be used in connection with the production and sale of the goods by the assessee. What is clear from the present transaction is that the master tape contained within it, music/picture in digital form.

3. There is no doubt that the music/ picture supplied on the master tape ought to be valued and has been valued as additional consideration that flowed from the buyer to the assessee, and its value has been accepted at rupee one per CD.

4. So far as the royalty payable for such music is concerned, even if it is agreed that such royalty is inextricably connected with the music and therefore would be used in connection with the production of the duplicate CDs, yet the Explanation requires that such use must not merely be in connection with the production but must also be in connection with the sale of such duplicate CDs.

5. The entirety of the duplicate CDs was sold only to the distributor who was the copyright holder. Obviously therefore the copyright value in the duplicate CD was not used in connection with the sale of such goods inasmuch as no part of the copyright which may have been passed on by the distributor to the assessee was used by the assessee in selling the duplicate CDs to the distributor

[1] Civil Appeal No. 6709 of 2004 [the judgment was pronounced on 23th April, 2015]
[2] Explanation to Rule 6 of the Valuation Rules, as it stood then, is relevantly extracted as under:
"Explanation – For the removal of doubts, it is hereby clarified that the value, apportioned as appropriate, of the following goods and services, whether supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale of such goods, to the extent that such value has not been included in the price actually paid or payable, shall be treated to be the amount of money value of additional consideration flowing directly or indirectly from the buyer to the assessee in relation to sale of the goods being valued and aggregated accordingly, namely:-
(i)…(iii)…
(iv) value of engineering, development, art work, design work and plans and sketches undertaken elsewhere than in the factory of production and necessary for the production of such goods."

who was himself the owner of the copyright.

6. Clearly therefore, on the assumption that the music/picture embedded in the master tape was inextricably bound with the copyright thereof, the copyright was not "used" by the appellant while selling the duplicate CDs to the distributor. The distributor having paid a lump sum royalty to the producer of the music, then sold, after the job work done by the appellant, the duplicate CDs in the market with the cost of the royalty loaded therein.

7. On the assumption that the music/picture component was the art work in the master CD, that alone was to be taken into account as it was necessary for the production of the duplicate CDs. Royalty payable for such music/picture could not extend to art work that was necessary for the production of duplicate CDs, as no part of it was in fact taken into account by either the distributor who was the copyright holder or the appellant in the job work done by the appellant.

8. The Hon'ble Supreme Court relied upon its earlier judgments in ***Joint Secretary to Government of India vs. Food Specialities Ltd***[3] and ***Sidhosons & Anr vs. Union of India***[4]**,** which decisions were rendered prior to the Valuation Rules being in force, for the position in law that the value of goodwill contained in a brand name would not form part of the assessable value of goods that were produced and sold only for the owner of the goodwill. The Hon'ble Supreme Court observed that in the present facts, the appellant also sold the duplicate CDs only to the distributor who was the owner of the copyright, and this enhancement could not be added as part of the value of goods sold in such cases.

9. The Hon'ble Supreme Court distinguished the judgment in ***Associated Cement Companies Ltd vs. Commissioner of Customs***[5]**,** which was rendered in the context of Rule 9(1)(b)(iv) of the Customs Valuation (Determination of Price of Imported goods) Rules, 1988, which was in *pari materia* to Rule 6 of the Valuation Rules. It observed that in the case of ***Associated Cement (supra),*** what was imported by the appellant was not merely paper, but drawings and designs on paper whose value had to be added for the reason that the appellants/importers were themselves going to exploit the intellectual content of the goods that were imported, while in the present facts, the appellants themselves did not exploit the intellectual content in the CD produced by them by way of sale as the sale by them could only be to the copyright owner himself.

10. Given that no part of the royalty can be loaded on to the duplicate CDs produced by the appellant, the Circular of 2002 which dealt with apportionment of royalty would have no application to the present facts.

ELP COMMENTS

This judgment has a huge impact on industries such as the music industry, software industry, auto industry etc where job-workers are engaged to mass-produce goods, which contain intellectual inputs (music, software, design etc).

Under Customs law, in terms of the settled position in law as laid down by the Hon'ble Supreme Court in ***Commissioner vs. Living Media (India) Ltd.*** [6], the licence fee and royalty paid by importer to licensor is includible in the value of goods purchased from the replicator of CDs. The decision of ***Living Media (supra)*** was rendered in the context of Rule 9(1)(c) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007 which requires the addition to assessable value *"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".* It is noteworthy that there is no comparable rule under the Valuation Rules in excise law.

Circular of 2002 had clarified that the cost of the master CD (supplied to job worker for replication) would include the royalty amount paid/payable by the music company for acquiring exclusive rights for the music/movie and the cost incurred in getting the original score recorded in a studio (if this has been incurred by the copyright owner)[7]. The said Circular specifically clarified that duty will have to be paid by the job-worker on this royalty amount also. However, the Hon'ble Supreme Court has held that the Circular of 2002 has no application to the facts before it.

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[3] [1985 (22) ELT 324 (SC)]
[4] [1986 (26) ELT 881 (SC)]
[5] [2001 (128) ELT 21 (SC)]
[6] [2011 (271) ELT 3 (S.C.)]; The review petition against the decision in *Living Media (supra)* has been dismissed by the Hon'ble Apex Court in *Soni Music Entertainment India Pvt. Ltd. vs. Commissioner [2012 (284) E.L.T. A58 (S.C.)]*
[7] In such cases, the Circular of 2002 has clarified that the most reasonable method would be to ascertain the royalty amount and studio hire charges contained in the wholesale price of the CDs at which the copy right owner sells, to its dealers, at arm's length. This could be done by determining the royalty amount plus the studio hire charges as a percentage of the net sale value (gross sale minus central excise duty element) of the music company or the copyright owner in respect of the recorded media. The figures of net sales and royalty payments are normally available in the balance sheets of these companies. This percentage will be used to determine the element of royalty cost attributable to each CD.