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TAX FLASH NEWS

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True up payments received to cover losses in India and marketing/advertisement expenses incurred for own business interest, do not influence transaction value of imports – CESTAT, New Delhi

Executive Summary

Customs, Excise & Service Tax Appellate Tribunal, New Delhi (CESTAT) in the case of Volvo Auto India Private Limited[1] (appellant) recently dealt with the issue on whether transaction value for related party imports is influenced on account of true up payments received from offshore parent entity as well as expenses such as advertisement, incurred by importer. The CESTAT observed that receipt of true up payments from the offshore parent entity to cover losses in India will not have any bearing on import value. Further, the advertisement and other such expenses are towards managing importer's own business affairs in India and not on behalf of supplier, thus same should not be included in the import value.

These issues are typically common in context of customs and transfer pricing regulations. The answer to a lot of these complexities lie in correct characterization of related party transactions as well as consistent disclosure under customs, transfer pricing, GST, financial accounting, forex regulations, etc. It is also crucial to ensure readiness of all documentation to demonstrate the transactions to the authorities. With increased use of technology and data analytics by authorities, it becomes even more critical for industry to develop a holistic view on disclosures made under different laws.

Facts of the case

The appellant is a 99.99 per cent subsidiary of offshore parent entity, Volvo Sweden and is required to manage distribution of imported goods as well as sales promotions for its business in India. For distribution, the appellant imported completely built units (CBUs) of motor vehicles from its offshore parent entity.

The import transaction was subject to examination by Special Valuation Branch (SVB) twice wherein transaction value was accepted.

The customs authorities challenged the acceptance of transaction value by SVB, based on following contentions:

- Impact of losses incurred by appellant, true up payment received and their difference (if any), on the import price was not considered by the SVB.
- Advertising and marketing expenses incurred by appellant as per the arrangement with foreign supplier should be includible in the value of imports.
- The price of similar cars with extra features sold by offshore parent entity to unrelated buyers viz, embassies in India was approximately 33% higher than sale price to appellant. The SVB failed to undertake in-depth analysis of comparable value based on this supply to unrelated buyers.

The appellant has filed the present appeal before CESTAT against the above contentions. The appellant, inter-alia, argued that since transaction value was accepted in the first SVB order, which has attained finality, it should not be open for customs authorities to challenge the subsequent SVB order.

CESTAT order

At the outset, the CESTAT noted that order of first appellate authority is inconclusive and should be set aside on this ground alone. This is for the reason that the said order neither held that the relationship between the parties has influenced the price nor did it provide the methodology for valuation.

However, the CESTAT decided to provide observations in respect of the various arguments. The CESTAT's key observations are as under:

- As regards **true up payment**, CESTAT observed that it will have to be evaluated if there is any additional consideration flowing from the importer to foreign supplier. It was observed that in appellant's case, such payments are flowing in a reverse order, from the foreign supplier to the importer, which if considered would even lower the invoice value.

[1] TS-217-CESTAT-2021-CUST

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Further, it was observed that the true-up payment was not obligatory under any law and therefore, offshore parent entity may or may not choose to cover the losses. Accordingly, neither the losses incurred, nor the amount received to recoup such losses could have any bearing on the transaction value.

- The CESTAT observed that **marketing and advertisement** expenses are includible only if required to be incurred as a condition of sale to satisfy the obligation of the offshore entity[2]. In the present case, the appellant was in the business of selling cars, which necessarily required them to promote sales, and incur such expenses. Therefore, such expenses cannot be termed as expenses incurred on behalf of foreign supplier even though these may indirectly benefit the foreign supplier also.
- In respect of **comparison of sale to unrelated retail buyers**, CESTAT noted that the cars sold to independent buyers (embassies) had additional security features. Further, price charged from unrelated buyers ought to be higher as these were sold in retail, while the appellant bought the cars in bulk, being a distributor. The CESTAT observed that such cars with additional features were not sold to appellant and the first appellate authority has not provided any mechanism for arriving at comparable value, by adjusting premium for retail sale and extra features.
- It is also important to note CESTAT's observation in respect **of challenge to subsequent SVB order** considering that the first SVB order has attained finality. The CESTAT noted that each Bill of Entry (BoE) is an separate assessment. Therefore, the principle of Res Judicata applies only to the extent of assessment of a particular BoE and is not binding on the assessee or the revenue with respect to any future imports.

Our comments

The above judgment is one of the few rulings in the Indian customs valuation domain where judicial authorities have commented on the impact of year-end adjustments on import value for customs purposes. World Customs Organization's Guide to Customs Valuation and Transfer Pricing, first published in 2015 and latest edition published in 2018, has delved in detail about the treatment of true up and true down on customs valuation. However, reliance upon such true up/ true down transfer pricing adjustments to assess the import value for customs purpose is recognized in 2016 Circular[3] prescribing the SVB process and is gaining momentum in valuation decision being made by the customs authorities now.

At a conceptual level, true-up/true-down transfer pricing adjustments are made periodically to demonstrate transfer pricing compliance and to ensure that the Indian entity's profit margin is within the arms-length range, in line with the normal industry practice. In case the profitability is not within arm's length range, the authorities (including customs) may view this as an indication that the dealings with related parties, including imports, may not be at arms-length. To strike the balance between competing interest of customs valuation and transfer pricing it is imperative to align the business practices from customs valuation and transfer pricing perspective. In this respect, various factors such as inter-company arrangement, functions of the company, its risk matrix, arms-length profit margin range, financial reporting, purpose code declared to bank etc. should also be taken into consideration.

The other issues covered, such as inclusion of marketing and advertisement expenses in transaction value are also important aspects which have been a subject matter of debate both under customs and transfer pricing.

This is an important judgement as it not only establishes relevant principles for adjustment in customs valuation but also, indirectly reinforces the interlinkage of customs regulations with transfer pricing law. Due cognizance should also be given to the disclosure made as per foreign exchange regulations and accounting principles. However, we would like to add that last word has not yet been made on this debate. We expect more granularity and detailing to emerge in business documentation, disclosures to the authorities and interpretation of law looking at different aspects of the transaction.

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[2] In terms of Rule 10(1)(e) of The Customs Valuation (Determination of Value of Imported Goods) Rules, 2007

[3] Circular No. 5/2016-Customs dated 9 February 2016

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KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
1st Floor, Lodha Excelus,
Apollo Mills,
N. M. Joshi Marg,
Mahalaxmi,
Mumbai – 400 011.
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011
Phone: +91 22 3989 6000, Fax: +91 22 3983 6000

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