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THE EMPIRE STRIKES BACK

Author: G. Natarajan, S. Jaikumar

Star Wars and Tax Wars are highly similar for their nail-biting thrills and neverending frills! Recently, in one of such colossal battles, the Hon'ble Apex Court has pronounced a path breaking judgement (we are sure, this will be a heart breaking judgement, for many!), in which, the impact of a "relationship" under job work, has been finely interpreted! {CCE Vs S.Kumar Limited _ 2005 – TIOL – 147 SC}

Job work and Ujagar Prints are Mona Lisa and her mystical smile! Eventhough, way back in 1989, the Apex Court had emphatically laid down the method of valuation for the goods manufactured on job work basis, in the landmark Ujagar Prints case, till date, the ratio laid down in that case has remained to be a Modern art. For the past two decades, everyone, be it the Revenue, Trade or Consultants, have tried to interpret the ratio based on their own understanding. In fact, this celebrated judgment has the rarest distinction of being the best fodder for tax planning (tax avoidance!).

As it has been so emphatically laid down that if the manufacture is undertaken on job work basis, the job worker has to pay duty only on the "landed cost of raw materials plus his conversion charges including his profits" and not on the selling price of the principal, most of the FMCG sector and the Pharmaceutical sector have taken this cue and resorted to large scale sub-contracting, and has been paying duty on this Ujagar value! Whereas, on one hand this lead to employment, growth of industry, improvement in the living conditions of rural folk, emergence of lot of small entrepreneurs, etc. leading to overall economic growth, on the other hand, it started burning the Revenue fingers, very badly!

Irked by the yawning gap between the value for which duty is paid by the job worker and the ultimate selling price of the commodities and the consequent duty foregone, the Government was urged to think of an ingenuous way to plug this huge "Revenue loss", thus giving rise to the new age valuation based on MRP under Section 4A of the Central Excise Act! By this MRP based valuation, the Revenue has successfully countervailed the peril of Ujagar valuation and today, most of the FMCG items and Pharma goods are brought under this MRP based levy!

This time tested Ujagar valuation has tempted bulk of the trade to opt for "job work" mode and avail the tax savings! As tax avoidance and tax evasion has only a silver line difference! There were attempts to cross over the thin line by creating dummy units, multiple units of same entity, related units, etc, as job workers and derive the benefit of the Ujagar valuation. Eventhough the Revenue was able to fix such bogus units, in respect of the "related units", it was handicapped.

Under Central Excise valuation, the "related persons" are treated specially and the value at which such "related person" sells the goods, is taken for assessment. But as Ujagar valuation was rendered under the residuary rule (Best judgement) of the Valuation Rules, there was no clue for the Revenue! In a number of decisions, the various benches of the Hon'ble Tribunal have held that there is no impact of "relationship" in Ujagar mode of valuation. Even, the larger Bench of the Hon'ble Tribunal in the case of Prafful Industries Ltd. Vs CCE – {2002-TIOL-01-CESTAT-DELLB}, has endorsed the same. But the aggrieved Revenue has been fighting the case till its last drop of blood and took up the matter to the Supreme Court. After two decades since the pronouncement of Ujagar, the Hon'ble Supreme Court has now revisited Ujagar Prints valuation!

The decision of the Hon'ble Supreme Court in the case of Empire Industries {2002TIOL-27-SC-CX} was the "OLD TESTAMENT" on job work valuation. In this case it was held that the job worker – processor cannot pay duty on his processing charges alone, but on the selling price of his customer/principal. This has been so emphatically laid down, in para 47 of the said decision, rendered by a three members bench.

The issue once again reached another three member bench of the Hon'ble Supreme Court in Ujagar Prints case – {2002-TIOL-01-SC-CX} (Ujagar I). The Bench felt that it would be appropriate, only if

duty is charged on job worker on the value of materials supplied and his conversion charges and the profit of the customer should not have been taken into account. However, in view of the contra decision by a coordinate bench in Empire Industries case, the Bench referred the issue to a 5 member bench, thus giving birth to Ujagar II case – {2002 – TIOL – 02 – SC – CX }. Though the decision upheld the view in Empire Industries case that duty cannot be charged on the processing charges alone, there was some lack of clarity as to what would then be the assessable value, between the two, viz., (a) Intrinsic value of the processed goods i.e. landed cost of raw materials plus the labour charges of job workers; or (b) the price at which such goods are sold for the first time in the wholesale market.

Result – Ujagar III – {2002-TIOL-03-SC-CX}. In Ujagar III, it was clarified that, in respect of the valuation of goods manufactured on job work basis, the assessable value shall be based on the landed cost of raw materials plus the conversion charges (which also includes the profit of the job worker) and not the ultimate selling price of the customer! Thus, even though the Constitution Bench in Ujagar II upheld the ratio of the "Empire Industries", while clarifying the same, Ujagar III made it as a "The Lost Empire"!

But, in none of the above cruise, the job worker was "related" to the customer/principal!

Now, in this recent judgement, the Hon'ble Supreme Court had the occasion to revisit the entire gamut of job work valuation, where in a case the job worker is "related" to the customer/principal. It has now been held by the Hon'ble Apex Court that, if the job worker is "related" to the customer/principal, the principles of Ujagar Prints would not apply and the valuation has to be done with reference to the selling price of the customer, thus reviving the ratio of the "Empire Industries"!

In terms of impact to either side, if Empire episode and Ujagar episode can be considered as the First and Second World Wars on Excise valuation, and if so, this S.Kumar is certainly the Third World War.

This recent decision has triggered several questions in our mind, for which we have attempted to find answers too;

a) *Whether a two member bench of the SC can change the decision on job work valuation, which has been settled long ago, by a five member bench?*

In as much as the issue of job worker being a "relative" of the customer has never been raised in Ujagar Prints, it cannot be said that the decision in Ujagar Prints has said the final word on valuation of goods manufactured by job workers, who are related to their customers. The Supreme Court had the occasion to go into the issue of valuation of goods manufactured by "related" job workers, only now. As such, it is not going against the Constitution Bench decision but deciding an independent issue, which was never decided.

b) *The present case appears to have dealt with a situation where there was a sale between the principal and processor. In the Ujagar case, there is no such sale between them and the goods always belonged to the principal. Based on the above, can the present judgement be distinguished from Ujagar Prints?*

Even though Para 3 of the Tribunal decision {2000 (117) ELT 439}, which was set aside by this present decision, and Para 2 of this present decision of the Hon'ble Supreme Court, would raise a doubt that the transaction involved in the case was a
"sale and purchase" and not at all a "job work", a careful reading of Para 8 & 10 of the Tribunal judgment would reveal that the transaction was based on job charges and hence job work. This has also been taken cognizance by the Hon'ble SC in Para 1 of the decision, where there is mention of job charges being paid. But, going by the theory of legal evolution, it is always possible that someday, someone can still read between the lines and drag the litigation caravan, on and on….

c) *Whether the concept of "related person" envisaged in Section 4 (3) (b) of the CE Act, 1944 would be applicable to determine the status of job workers also?*

The following four classes of persons / entities are considered to be "related", as per the section 4 (3) (b).

a. Inter-connected undertakings.
b. Relatives (applicable for individuals).
c. Relative and distributor or sub-distributor of such relative distributor.
d. Persons / entities having mutuality of interest.

As the said definition is also in the context of valuation of excisable goods, the same shall apply, to determine as to whether the job worker is related to the customer or not.

d) What is the relevance of Rule 9 and 10 of Valuation Rules, in case the jobworkers are related to the customer?

As per section 4 (1) (a), the transaction of value shall be the assessable value, if the following conditions are satisfied.

- There is a sale.
- Delivery at the time and place of removal.
- Assessee and the buyer are not related.
- Price is the sole consideration for sale.

If any of the condition are not satisfied, as per section 4 (1) (b), recourse has to be made to the Central Excise Valuation Rules, 2000. The different rules of valuation provide for different contingencies. For brevity, let us not go into the details, for the present purpose. As only Rule 9 and 10 of the Valuation Rules, deal with the "related" persons, let us restrict to address only them.

According to Rule 9 of the Valuation Rules, if the assessee **sells** the goods to or through the following persons, viz,

a. Relatives (applicable for individuals).
b. Relative and distributor or sub-distributor of such relative distributor.
c. Persons / entities having mutuality of interest.

the assessable value shall be the transaction value at which the goods are subsequently sold by these persons to non related buyers.

As per Rule 10 of the Valuation Rules, if the assessee **sells** the goods to interconnected undertakings, the price at which the goods are subsequently sold by the inter-connected undertakings to non related buyers, would be the assessable value, **only if** the two inter-connected undertakings (assessee – seller and buying company) are either

- Relatives; or
- Relative and distributor or sub-distributor of such relative distributor; or
- Having mutuality of interest; or
- Buying company is a holding or subsidiary company of the assessee.

In other words, if none of these additional conditions are satisfied, even if the buying company is an inter-connected undertaking to the assessee, the transaction value between the assessee and the buying company would be the assessable value. In other words, if these additional conditions are not satisfied, the inter-connected undertaking would not be considered as being "related" to the assessee at all.

Coming to the relevance of the provisions of these Rule 9 and 10 of the Valuation Rules, to job workers, it may be observed that the said rules are applicable, only if the goods are **sold to or through** related persons. In case of manufacture by job workers, the job workers would neither be selling the goods to

the customers (principals – sending the raw materials) nor be selling the goods through them. In fact, their obligation is only to manufacture and return the goods to the customer (principal) and there is no sale of the goods, at their hands. As such, it appears that Rule 9 and 10 are not at all applicable for job workers.

As stated earlier, valuation of goods manufactured on job work basis, is done only by the residuary rule of valuation. Even the Ujagar principle, owes its origin to the residuary valuation Rule. Now, there are two landmark decisions on job work valuation. Ujagar – if the job worker is not related and S.Kumar – if the job worker is related. Once recourse is made to the residuary valuation Rule, to arrive at the assessable value of goods manufactured on job work basis, either of the two decisions have to be applied.

If the job worker is not related – the assessable value shall be the landed cost of raw materials plus conversion charges of the job worker. (Ujagar ratio)

If the job worker is related – the assessable value shall be the selling price of his customer, subject to permissible abatements / deductions. (Empire ratio)

Before Parting…

The definition of "inter-connected undertaking" is borrowed from the provisions of MRTP Act, which is sweeping in nature. As per Sec 2 (g) of the MRTP Act, even if one partner is common, then they are inter- connected undertakings. As per Sec 4 (1) (c) of the Central Excise Act, such "inter-connected undertakings" are deemed to be "related" persons. And that is the reason why Rule 10, apart from being an "interconnected undertaking, has included the above stated additional conditions, to adopt the related buyer's value. The present S.Kumar's judgement speaks only of a "related person" and there are no other conditions attached thereto. If so, as per the judgement, even a plain inter-connected undertaking is a "related" person and there is no need of any additional conditions!

It just reminds us of the golden words of the famous Tamil poet, Kaniyan Poonkundranaar, "Yaadhum Oorey, Yaavarum Kheylir", which means, "Any town is our town. Everybody is our relative"!