Confusion related to IT Sector would continue under the new ST Law – June 19, 2012

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S Sivakumar, CA

As is well known…. levy of indirect taxes and especially service tax, on the IT Sector,represents one of the most complicated chapters. If one expected that some clarity could emerge under the new service tax law, one is bound to be disappointed and depressed.

Consider these……

New statutory provisions and extracts from the TRU Circular

In terms of Section 66E(d) of the Finance Act, 1994, 'development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software' is a declared service. The existing definition of information technology software services under Section 65(105)(zzzze) covers the following activities, viz.

(*i*) development of information technology software,
(*ii*) study, analysis, design and programming of information technology software,
(*iii*) adaptation, upgradation, enhancement, implementation and other similar services related to information technology software,
(*iv*) providing advice, consultancy and assistance on matters related to information technology software, including conducting feasibility studies on implementation of a system, specifications for a database design, guidance and assistance during the start-up phase of a new system, specifications to secure a database, advice on proprietary information technology software,
(*v*)providing the right to use information technology software for commercial exploitation including right to reproduce, distribute and sell information technology software and right to use software components for the creation of and inclusion in other information technology software products,
(*vi*) providing the right to use information technology software supplied electronically;
The TRU circular dated 16-3-2012 contains the following clarifications :

5.4 Development, design, programming, customization, adaptation, up gradation, enhancement, implementation of information technology software

The term 'information technology software' has been defined in section 65B of the Act as 'any representation of instructions, data, sound or image, including source code and object code, recorded in a machine readable form, and capable of being manipulated or providing interactivity to a user, by means of a computer or an automatic data processing machine or any other device or equipment'.

5.4.1 Would sale of pre-packaged or canned software be included in this entry?

No. Sale of pre-packaged or canned software is in the nature of sale of goods and is not covered in this entry.

5.4.2 Is on site development of software covered under this entry?

Yes. On site development of software is covered under the category of development of information technology software.

5.4.3 Would providing advice, consultancy and assistance on matters relating to information technology software be chargeable to service tax?

These services may not be covered under the declared list entry relating to information technology software. However, such activities when carried out by person for another for consideration would fall within the definition of service and hence chargeable to service tax if other requirements of taxability are satisfied.

5.4.4 Would providing a license to use prepackaged software be a taxable service?

It is a settled position of law that prepackaged software or canned software or shrink wrapped software is goods. (Supreme Court judgment in case of Tata Consultancy Services vs State of Andhra Pradesh [2002(178) ELT 22(SC) refers]. To determine whether providing license to use a software is a service or sale of goods it would need to be seen whether the license to use packaged software tantamount to 'transfer of right to use goods'. 'Transfer of right to use goods' is deemed to be a sale under Article 366(29A) of the Constitution of India and transfer of goods by way of hiring, leasing, licensing or any such manner without transfer of right to use such goods is a declared service.

On a combined readings, the following conclusions might emerge, viz.

Sale of packaged software

Sale of pre-packaged software is not leviable to service tax, on the basis of fact that, pre-packaged software is to be treated as 'goods'. Great… But, what happens to the levy of central excise duty on pre-packaged software? One would have to presume that central excise duty would continue to be attracted, on sale of pre-packaged software, in terms of Notification No. 12/2008-C.E., dated 1-3-2008, as there have been no changes in terms of the central excise levy on pre-packaged or shrink wrapped software.As per the Explanation appended to Notification No. 17/2010-CE dated 27-2-2010 and Serial No. 27 to Notification No. 6/2006-CE dated 1-3-2006 'Software' falls under heading 8523 80 20 of the Central Excise Tariff Act. Hence, central excise duty would continue to be levied on sale of packaged software.

Software licensing

The new entry under 'declared services' does not incorporate the transfer of right to use software licenses, which was specifically covered under the earlier list. The TRU Circular, as aforesaid, also makes a rather bold comment that, license to use packaged software would tantamount to 'transfer of right to use goods' and consequently, is not subject to the service tax levy. This is a major U turn by the Government vis-à-vis the current provisions contained in Section 65(105)(zzzze). As far as I know, the question of transfer of software without transfer of right to use the software does not work, in the IT Sector. Hence, it seems that, no service tax can be levied on licensing of packaged software. However, this view would seem to contradict with Section 66E(c), which talks of 'temporary transfer or permitting the use or enjoyment of any intellectual property right' being a declared service. Now, it seems that, clause (d) and clause(c) are presenting conflicting views on the levy of service tax on licensing of software, in as much as, while the former entry says that licensing of any IP (which should include software) is a taxable service, the latter entry does not include transfer of right/licensing of software. In my view, clause (d) being a specific entry related to IT software, would prevail over the entry covered under clause(c) of Section 66E.

Notwithstanding this huge confusion……. We must be aware of Notification No. 17/2010-CE, issued on February 27, 2010 exempting packaged software or canned software, falling under Chapter 85 of the CE Tariff, from so much of the duty of excise leviable thereon as is equivalent to the excise duty payable on the portion of the value representing the consideration paid or payable for the licensing of the software, provided that a declaration is made in respect of such consideration and further provided that, the person providing the right to use shall be registered under the provisions of the Finance Act, 1994. A plain reading of Notification no. 17/2010-CE suggests that, either central excise duty or service tax should be paid on licensing of software. Assuming that, service tax is no longer leviable on licensing of software, under the new service tax law, can central exsise duty be levied? Since most software product players were charging service tax on licensing, there were able to escape from the mischief arising out of the levy of central excise duty on licensing of software. Notwithstanding the fact that, there are no machinery provisions in the central excise law to levy duty on software licenses, especially when these are given out in the electronic form, Notification

No. 17/2010-CE could still create a lot of confusion for the IT Sector. Given a choice between central excise duty and service tax, one might feel that the latter is a lesser evil, perhaps.

Software services could be works contracts

Now… let's see how customized software or software services could get treated under the new law. As of now, these are chargeable to service tax even under the existing law, under Information Technology Software Services. Service tax would continue to get levied, under the new law, under clause (d) of Section 66E. However…there could be a major issue in terms of the expanded definition of 'works contract, in terms of Section 65B(44) of the Finance Act, 1994, which reads as follows:

"works contract means a contract wherein transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods and such contract is for the purpose of carrying out construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, alteration of any movable or immovable property or for carrying out any other similar activity or a part thereof in relation to such property".

It is important to note that the new definition of works contract, reproduced above, is similar to the definition of works contract, under the VAT law. In many States including Karnataka, software development is a specific entry under the Schedule listing works contracts. Hence, we need to assume that, once a transaction is treated as a works contract under the VAT law, such a transaction should also be treated as a works contract under the service tax law. Hence, software development, being a works contract under the VAT law, would also be a works contract under the service tax law. Taking this reasoning further, one can assume that, customized software/software services involving transfer of software modules in the nature of goods, would have to be treated as a works contract. Since, under the new service tax law, service tax is to be levied only on the 'service portion' of works contracts, most software development activities could suffer both VAT and service tax. Of course, if only services are involved, these would be pure services and no VAT can be levied. If a view is taken that, software development is a works contract, service providers would be required to go by Rule 2A of the Service Tax (Determination of Value) Rules, 2006, as amended by Notification No. 24/2012 dated June 6, 2012, which, interalia state that, service tax is to be paid on 40% of the gross amount involved in the case of original works, when separate books indicating the value of services, are not maintained, under clause (B) of Rule 2A(ii).

Software AMCs could be works contracts

Under the current law, Software Annual Maintenance Contracts are subject to service tax levy at the full rates. Moreover, VAT is also charged, treating these transactions as works contracts under the VAT law. In Karnataka, most software players, charge VAT on 70% of the AMC value and service tax on 100% of the AMC value. However, under the new service tax law, the definition of works contract would include Software AMCs, unless the entire AMC is one of providing service. In most practical cases, upgradations, updations, etc. of software is given as part of the AMC, which would make these transactions as works contracts. Hence, under the new service tax law, service tax can be levied only on the 'service portion' of the works contracts, service tax could get levied on 60% of the AMC value under clause (C) of Rule 2A(ii). Of course, this could still result in both VAT and service tax being levied on 30% of the AMC value, considering the fact that, under the Karnataka VAT Act, VAT is to be levied on 70% of the works contract value where separate books are not maintained.

Before concluding…..

Not all software transactions including AMCs could be treated as works contracts, unless there is a transfer of software or software modules, in the nature of goods. These could now get treated as works contracts, under the new service tax law.

The confusion related to the levy of central excise duty on licensing of packaged software would continue, unless the Government comes out with a clarificatory circular.

Quite sadly….. the much needed clarity on levy of service tax on the IT Sector is missing, under the new service tax law.

(The Author is Director, S3 Solutions Pvt Ltd, Bangalore)