# Customised Software-Service, Sale or Both VST – October 24, 2008

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**Customised Software – Service, Sale or Both?**
The Government, in its infinite wisdom, brought "Information Technology Software Services" ("ITSS") into the service tax net, with effect from May 16, 2008.

As per section 65(105)(zzzze) of the Finance Act, 1994, inserted vide Finance Act, 2008 with effect from May 16, 2008, "any service provided or to be provided" to any person, by any other person in relation to information technology software for use in the course, or furtherance, of business or commerce, including-

(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) acquiring 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) acquiring the right to use information technology software supplied electronically; is a taxable service."

In terms of section 65(53a) inserted vide Finance Act, 2008 with effect from May 16, 2008, "Information technology software" means 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 an user, by means of a computer or an automatic data

processing machine or any other device or equipment.

The letter F. No. 334/1/2008-TRU dated February 29, 2008, issued by the Tax

Research Unit of the Government clarifies as follows-

“4.1-2 Software consists of carrier medium such as CD, floppy and coded data. Softwares are categorised as “normal software” and “specific software”. Normalised software is mass market product generally available in packaged form of the shelf in retail outlets. Specific software is tailored to the specific requirement of the customer and is known as customised software.

4.1-3 Packaged software sold off the shelf, being treated as goods, is leviable to excise duty at 8 per cent. In this Budget, it has been increased from 8 per cent to 12 per cent vide Notification No. 12/2008-CE, dated March 1, 2008.

4.1-4 IT software services provided for use in business or commerce are covered under the scope of the proposed service. Said services provided for use, other than in business or commerce, such as services provided to individuals for personal use, continue to be outside the scope of service tax levy. Service tax paid shall be available as input credit under Cenvat Credit Scheme.

4.1-5 Software and upgrades of software are also supplied electronically, known as digital delivery. Taxation is to be neutral and should not depend on forms of delivery. Such supply of IT software electronically shall be covered within the scope of the proposed service.

4.1-6 With the proposed levy on IT software services, information technology related services will get covered comprehensively.”

As is the case with the service tax law, the definition of ITSS is an “inclusive” one, which could bring in virtually everything related to the software industry, under its wide ambit. Let’s look at some of the confusions and controversies that could

arise.

**Controversy No. 1:** In terms of clause (i) of the definition, is software development a taxable service or services rendered in relation to software development, a taxable service? If a broader view is taken, practically, all development activities related to unbranded software could come under the service tax net, while on the other hand, taking a view that it is only the services rendered in relation to the development of the unbranded software that are covered would only bring related services like consultancy, writing of the codes, etc. In my opinion, a restricted view of treating services related to software development as taxable, would only be justified.

**Controversy No. 2:** In terms of clause (vi), is acquiring the right to use information technology software supplied electronically is a taxable service or is "service rendered in relation to acquiring the right to use information technology software supplied electronically" is a taxable service? By the usage of the wonderful English language in a rather loose manner, lots of controversies are cropping up here. Is it that the levy of service tax is attracted if the right to use "ITSS supplied electronically" is effected electronically, OR is it that, the right to use ITSS is "supplied electronically", as both are possible ways of doing business in the software industry.

What would happen if a software developer develops customised software and transfers the right to use this to his customer, in a physical medium like a compact disk, on the basis of paper licence. Surely, this transaction would be outside of the service tax levy as there is no electronic medium involved, either in terms of supply

of the software or in terms of transferring the right to use software. Can the transfer of right to use customised software through a paper licence in a CD, though not falling under clause (vi) of the definition, be still covered by clause (i) whose sweep seems to very wide. Perhaps, not, going by the rules of interpretation of taxing statutes wherein, a specific entry would prevail over a genal entry.

What would happen if a software company, without transferring the right to use customised software allows its customers to use or download its on-line program? Perhaps, this activity will not fall under ITSS and also under any of the other taxable services, in my view.

**Controversy No. 3:** In terms of clause (iii), adaptation, upgradation, enhancement, implementation and other similar services related to information technology software is taxable. What is the import of the word “similar” here? And, how does clause (i) and clause (iii) go, if one is to take a combined look at the two clauses? If a software company takes an unbranded/customised software from another developer, re-writes the codes and then, returns software, let’s say. Here, there is no question of transferring of right to use software and hence, this would not fall under clause (vi). Perhaps, this activity does not amount to adaptation, upgradation, enhancement or implementation. Will re-writing of codes, etc., get covered by the word “similar”? I don’t know. Perhaps, this activity could get covered by business auxiliary services or business support services. But, going by the concept of “ejusdem generis” re-writing of codes, etc., might not fall under

ITSS.

**Controversy No. 4:** Is customised software goods? A billion dollar question, indeed.

The Supreme Court in *Tata Consultancy Services* v. *State of Andhra Pradesh* [2004] 137 STC 620; [2004] TIOL 87 SC CT-LB, had held that canned software or, computer software packages sold off the shelf are goods. The immediate examples of canned software that we can recollect are Oracle, Lotus, etc. In this landmark case, the apex court had discussed at length, branded and unbranded software and had held, inter alia, that there is no distinction between the two, as in both cases, the software is capable of being abstracted, consumed and used and it can be transmitted, transferred, delivered, stored, possessed, etc. Of course, the apex court did not hold unbranded software to be goods, as this was not a subjectmatter before it, in this case. Moreover, there are issues like situs of the sale, etc., vis-a-vis sale of unbranded software. But, the controversy is far from over and going by the *TCS* case [2004] 137 STC 620; [2004] TIOL 87 SC CT-LB, it seems clear that unbranded or customised software can also be treated as goods.

In terms of the applicability of sales tax or VAT on the software industry, sale of branded software and sale or transfer of licences irrespective of whether these licences pertain to canned software or customised software, are transactions attracting the VAT levy. This is at least the case, in so far as the provisions of the Karnataka Value Added Tax Act, 2003 are concerned, as licences are goods. Unlike clause (vi) of the definition of ITSS in section 65(105)(zzzze) which only talks about transfer of software electronically, no such distinction is recognised in the VAT law. Any sale or transfer of licence, whether pertaining to branded

software or customised software, attracts VAT at 4 per cent, in Karnataka. It is another matter that transfer of licence vis-a-vis customised software in electronic form, also attracts service tax.

In my strong view, post *TCS* judgment [2004] 137 STC 620 (SC); [2004] TIOL 87 SC CT-LB, one can take a view that sale of customised software or transfer of licence related to customised software is a sale activity. Moreover, we also have the judgment of the Supreme Court in *Associated Cement Companies Ltd.* v. *Commissioner of Customs* [2001] 124 STC 59; [2002] TIOL 08 SC wherein it was held that computer software is "goods" even if it is copyrightable as intellectual property.

Under the Central excise law, all software whether branded or customised is treated as excisable goods under Tariff No. 8523 80 20. Of course, by virtue of Notification No. 6/2006-CE dated March 1, 2006, excise duty is exempted on all software other than canned or packaged software. Of course, the treatment of customised software as excisable goods is another strong argument that customised software is "goods".

**Controversy No. 5:** We have seen that customised software can be treated as "goods" as well as "services". Can customised software be treated as goods plus services, i.e. as works contracts? Yes, of course.

For instance, under the Karnataka Value Added Tax Act, 2003, customised software is, very interestingly, treated as a works contract, falling under item No. 11 of the Sixth Schedule to the KVAT Act, which lists works contracts. Item No. 11, by the way, reads "Programming and providing of computer software". We also have the benefit of the judgment of the Karnataka High Court in *Inventa Software (India) Private Ltd., Bangalore* v. *Additional Commissioner of Commercial Taxes,*

*Zone-1, Bangalore* [2008] 17 VST 362; [2006] 60 Kar. LJ 208 (HC)(DB). In this landmark case, the Division Bench of the Karnataka High Court had held, based on the apex court's judgment in *TCS* case [2004] 137 STC 620; [2004] TIOL 87 SC CT-LB that development of customised software is a works contract attracting sales tax levy under entry 22 of the Sixth Schedule of the Karnataka Sales Tax Act, 1957, under "Programming and providing computer software". Given the fact that the same words are used in entry 11 of the Sixth Schedule of the KVAT Act, 2003, the Karnataka HC decision in the *Inventa* case [2008] 17 VST 362; [2006] 60 Kar. LJ 208 (HC)(DB) becomes a binding precedent for treatment of customised software under the sales tax law in Karnataka.

This landmark judgment of the Karnataka High Court holding that customised software development is a works contract throws up, several interesting controversies. Given the fact that a works contractor can claim a deduction of 25 per cent towards labour charges in terms of rule 3(2)(m) of the Karnataka Value Added Tax Rules, 2005, it becomes clear that a customised software developer can choose to pay VAT at 4 per cent under the KVAT Act, 2003, on 75 per cent of the value of the software contract. By implication, with the imposition of service tax on ITSS, the customised software developer can choose to pay service tax on 25% of the value of his contract.

Is this approach legally sustainable? Very much, if we consider the judgment of the Supreme Court in *Imagic Creative (Pvt.) Ltd*. v. *Commissioner of Commercial Taxes* [2008] 12 VST 371 (SC); [2008] TIOL 04 SC-VAT, wherein it has been held that service tax and VAT (sales tax) are mutually exclusive. Of course, this landmark judgment was delivered by the Supreme Court in the context of the Karnataka Sales Tax Act.

Hence, it is legally sustainable for the customised software developer to go by the works contract route and opt to pay VAT (which is at 4 per cent in most States) on the "goods" portion, which is normally fixed at 70 per cent to 75 per cent of the value of the contract, and pay service tax at 12.36 per cent on the balance value of the contract, representing the "services" portion. Such a view is also sustainable in terms of the Supreme Court's decision in *BSNL* case reported in [2006] 145 STC 91; [2006] TIOL 15 SC-CT-LB.

**To part with. . . .**

Given the current situation that customised software can be treated as goods, services and also as works contracts, it becomes extremely difficult for the IT sector to decide on the strategy to follow. A practical and legally sustainable strategy for the customised software developers would be to go under the works contractor route and opt to pay both VAT and service tax, on the respective portions constituting the "goods" and the "service" portions of the contract. At least, this strategy would satisfy both the Departments. This approach would also be justified from the service tax angle, in as much as, the "goods" portion is allowed to be deducted while calculating the gross amount charged by a service provider, in terms of Notification No. 12/2003, which, in my view, is very much applicable to customised software development contracts.

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