Excise duty on Packaged Software Licenses – July 10, 2009

Excise duty on Packaged Software Licenses – Government opens pandora's box yet again

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AS has been extensively reported, through Notification No. 22/2009-CE dated July 7, 2009, the Government has abolished Central Excise Duty/Counterveiling Duty on Packaged/Canned software to the extent of value / consideration paid or payable for the right to use such packaged/canned software.

As is known, central excise duty on packaged software was levied for the first time, thro' Notification No. 49/2006-CE dated 30.12.2006 under which 8% duty was imposed on

software. While Sub-heading 8524 was deleted, a new tariff 8523 80 20 – Information Technology software' was created. The rate of duty was fixed at 8%. Exemption, however, was granted to 'Customized Software' vide Notification No. 6/2006-CE dated 1.3.2006, as amended from time to time. In terms of Notification No. 6/2006-CE dated 1.3.2006 (Sl. No. 27), exemption is given to "any customized software (that is to say, any custom designed software, developed for a specific user or client), other than packaged software or cannedsoftware.

The explanation to Notification 6/2006-CE which has now been reproduced in Notification No. 22/2009-CE reads as follows:

"For the purposes of this entry "packaged software or canned software" means software developed to meet the needs of variety of users, and which is intended for sale or capable of being sold, off the shelf."

Now, with the issuance of this Notification No. 22/2009-CE, the Government would seem to have opened the Pandora's box, yet again. Consider these…

++ It is a well known fact that, in the packaged software industry, a vast majority of the transactions happen thro the process of transferring the right the packaged software, to a customer. The intellectual property or development rights related to the packaged software are always retained with the software developer. Packaged software, by its very definition, is something which is capable of being sold off the shelf. Hence, a software package which is developed for a specific user to suit his purposes, cannot be called packaged or canned software. On the other hand, development of software for a particular customer would be customized software. I am not, therefore, able to understand the logic involving a packaged software developer 'manufacturing' and selling packaged software for a higher price which would include a price for the transfer of the software license. In all probability, this is a nonexistent situation, as in most cases, the price of the packaged software is equivalent to the price of the software license. This basic fact that selling the packaged software and licensing the software means the same thing, in most cases, seems to have been overlooked by the Government.

++ Now, let's get into the modes of the transfer of the right to use the packaged software. As is known, software developers use a variety of methods including paper licenses, licenses transferred thro' mail, licenses which can be downloaded from the Net, licenses contained in 'patches, etc. The Notification No. 22/2009 does not talk about the

mode of transfer of the license. Hence, it is to be assumed that all modes of transfer of the packaged software are covered by the Notification.

++ Here, is the googly. The Notification says that the exemption contemplated by the Notification is applicable only to the transfer of the right to use the packaged software for commercial exploitation including the right to reproduce, distribute and sell such software and the right to use the software components for the creation of and inclusion in other information technology software products. What do the words 'commercial exploitation' means, in the context of software? The Supreme Court has handled this very important question in State Bank of India vs. Collector of Customs 2000 (115) E.L.T. 597 (S.C.) and has held that use of an imported software and manual by the SBI under terms of strict confidentiality did not amount to 'commercial exploitation' of the imported software. It is well know that, the right to use packaged software, in most cases, is restricted to the use of the software by the licensees, to be used only for authorized internal purposes and for internal use. Consequently, it is clear that purchase of the license of packaged software forinternal use, does not amount to 'commercial exploitation' of the packaged software and would consequently, continue to be charged to central excise duty, as confirmed by

Notification No. 22/2009.

The major question that arises here is…. how can the seller of the licenses determine whether the buyer of the licenses would use these for commercial exploitation and consequently, take advantage of Notification NO. 22/2009, is anybody's guess.

++ It is fairly well recognized that any software license transferred electronically and sale of software keys/patches or licenses transferred through the internet download mode are services and the provisions of the Central Excise Act are not attracted. In the instant case, the Notification seems to suggest that, licenses for packaged software transferred or sold for non 'commercial exploitation' would still be covered by the central excise levy. This situation is not legally sustainable and the Government would seem to contradict itself.

++ Going by the new Notification, even for the sake of argument assuming that transfer of licenses for commercial purposes are not to be considered for levy of central excise duty, such a 'manufacturer' is required to register himself under the Finance Act with the Service tax Department and though, the Notification doesn't say that in so many words, the intent seems to be that, service tax is to be paid on such transfer of licenses. This again, is against the provisions of the Finance Act, wherein, on electronic transfer of licenses are covered by the service tax levy. One can see the utter confusion that prevails in the minds of theRevenue in as much as, under the central excise law, after Notification 22/2009, all transfers of licenses is covered by service tax.

++ Despite that, as per the central excise law, licenses are also treated as goods, can somebody tell me if any packaged software developer selling/transferring software licenses has been paying central excise duty? Where are the rules that can be applied for levying central excise duty on licenses, which this new Notification would have us believe, have always been there. The fact is that, the central excise law and procedures just don't cover cases where licenses are sold.

++ It seems clear that Notification No. 12/2003 is prospective. Is it then open for the Central Excise Department to insist on central excise duty to be paid by packaged software manufacturers for the period starting from January 1, 2007 till the date of the

new Notification. This very thought could be nightmarish for the packaged software industry.

++ Based on this notification, import of licenses for packaged software would also be exempt from CVD, with effect from July 7, 2009. Even otherwise, though packaged software licenses are excisable goods, there is no methodology prescribed by the Customs Act or the Customs Rules for the levy of CVD on import of licenses in the non-physical form. From now on, import of packaged software licenses would be outside the purview of the CVD levy.

++ The fact that packaged software licenses are not subject to central excise levy, by virtue of Notification No. 22/2009 leaves the field open for service tax and VAT. While, undoubtedly, VAT is applicable on sale of all software licenses irrespective of the mode of transfer, on a strict interpretation, service tax cannot be charged on a sale transaction involving sale of licenses being goods. We have the benefit of Notification 12/2003 as well as an array of cases decided by the Supreme Court and the High Courts to the effect that atransaction involving a 'sale' cannot be subjected to the service tax levy.

++ The position of law, emerging after the decision of the Supreme Court in the TCS case and the Madras High Court in the Infosys case, is that, both packaged software and customized software are goods as per the sales tax/VAT laws. Software licenses, whether for packaged software or for customized software, are also goods. This being so, service tax cannot be levied on a sale transaction, as held by the Supreme Court in the BSNL case. The Government has also been kind enough to exempt packaged software licenses forcommercial exploitation, from the levy of central excise duty.

++ Most importantly, are we then coming to a view that software licenses, irrespective of whether they are for packaged software or for customized software, being goods, can only be subjected to the levy of sales tax/VAT and not to central excise duty and service tax.

Yes, in my opinion. Software licenses would now only be exigible for the levy of VAT, notwithstanding the confusion about 'commercial exploitation' of the licenses.

++ What about software services? Most State Governments are taking a view that customized software is also goods, especially after the Madras High Court decision in the Infosys case. Customized software sold /transferred through the licensing route would be a safer strategy as, it can be argued that, such transactions, having suffered VAT, cannot suffer service tax. Software services rendered, without any transfer of modules, etc. might still be covered under service tax.

Before concluding ...

++ After the introduction of service tax levy on 'Information Technology Software Services' with effect from May 16, 2008, there has been a demand from the software industry on the removal of the double taxation on software licenses, in terms of levy of VAT and Service tax. There has never been a confusion as regards the levy of central excise duty and service tax. Instead of clarifying the levy of service tax on software licenses, the Government has ended up barking up the wrong tree, by issuing Notification No. 22/2009.

++ Notification No. 22/2009 could considerably help importers of software packages, in the[physical medium. Due to a total lack of knowledge and understanding, the Customs

Ports have been treating all software packages imported through the physical medium like CDs, etc. as packaged software and subjecting them to the levy of CVD. This Notification would ensure that CVD is not levied on imports by resellers/distributors, which can be held to be commercially exploiting the packaged software.

++ The Board should clarify on the intent behind the Notification No. 22/2009 being made applicable only for licenses which are not commercially exploited by the buyers. It beats my understanding, for sure.

++ Can the Delhi babus be put through a refresher course which would help them better understand the software industry? And, when will this perennial confusion about what constitutes packaged software and what constitutes customized software end? With Mr Nandan Nilekani around, in Delhi, one would expect the Government to better understandthe software industry.

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