Indirect taxes on customized software-Madras HC delivers a blow on VST – Nov 21, 2008

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S. Sivakumar, C.A.1

Indirect Taxes on Customised Software — Madras High Court Delivers a Punch!

The Madras High Court has delivered a landmark judgment in a case involving the software major, Infosys Technologies Ltd. v. Special Commissioner & Commissioner of Commercial Taxes [2008] 17 VST 256 (Mad); [2008] TIOL 509 (Mad). The High Court, on the basis of the apex court's decision in the Tata Consultancy Services v. State of Andhra Pradesh [2004] 137 STC 620 (SC); [2004] TIOL 87 (SC) CT LB, has held, inter alia, as follows, vis-a-vis customised software:

Sales tax—if the software whether customised or non-customised satisfies the Rules as a "goods", it will also be "goods" for the purpose of sales tax—goods may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold; and (c) capable of being transmitted, transferred, delivered, stored and possessed. If a software whether customised or non-customised satisfies these attributes, the same would be goods.

Undoubtedly, the apex court's decision in the TCS case [2004] 137 STC 620; [2004] TIOL 87, wherein it had observed, inter alia, that customised software could also be treated as "goods" has proved to be the ammunition for the latest decision from the Madras High Court. The fact remained that the apex court's observations on the possibility of customised software also being treated as "goods", rendered in the context of the TCS case [2004] 137 STC 620 (SC); [2004] TIOL 87 (SC) which had actually dealt with the levy of sales tax on "branded or packaged software" did not constitute a legal precedent, as the very issue of levy of sales tax

on customised software was not a subject-matter before the apex court in the TCS case [2004] 137 STC 620; [2004] TIOL 87. With the latest decision from the honourable Madras High Court holding that customised software is also "goods", the differentiation between packaged software and customised software would become irrelevant, for sales tax/VAT purposes, though such differentiation is still relevant for service tax purposes, as we will see later, in this article.

Writing in VST earlier [See [2008] 17 VST (Journal) 33], I had referred to the judgment of the Karnataka High Court in the Inventa case [Inventa Software India (Private) Ltd., Bangalore v. Additional Commissioner of Commercial Taxes, Zone- 1, Bangalore [2008] 17 VST 362 (Karn); [2006] 60 Kar. LJ 208], wherein it had been held that customised software development is a works contract, for purposes of levy of sales tax, in Karnataka. A combined reading of these two important High Court judgments which have been delivered on the basis of the apex court's decision in the TCS case [2004] 137 STC 620; [2004] TIOL 87, clearly establishes the legal dictum that service tax cannot be levied at all, on customised software, notwithstanding the Government's views to the contrary.

As is known, the Government had made a serious attempt at subjecting the entire software industry to the levy of indirect taxes, either in the form of Central excise duty or in the form of service tax. The Government's intention to subject packaged software to Central excise duty and customised software to service tax is very clear from the CBE&C TRU letter F. No. 334/1/2008-TRU, dated February 29, 2008, relevant extracts of which are reproduced below:

"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 eight per cent. In this budget, it has been increased from eight per cent to 12 per cent vide Notification No. 12/2008-CE, dated March 1, 2008.

4.1-4 Information Technology 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." The Government's intention to 'comprehensively tax the software sector' would

seem to have come a cropper, with the honourable Madras High Court holding that customised software is "goods". I've tried to analyse the broad implications arising out of this landmark judgment, from the point of levy of central excise, customs, service tax and TDS on customised software transactions.

Is VAT/Service tax applicable on sale of customised software or sale of software licences?

In the aftermath of the decision from the Madras High Court, customised software would attract sales tax or VAT. In some cases, customised software can also be considered as works contracts, as is the case in Karnataka, in which case, VAT could get levied on the "goods" portion of the contract, with service tax getting levied on the "services" part of the contract. This approach would be consistent with the decisions of the apex court in the Imagic Creative Pvt. Ltd. v. Commissioner of Commercial Taxes [2008] 12 VST 371; [2008] TIOL 4, the Bharat Sanchar Nigam Ltd. v. Union of India [2006] 145 STC 91; [2006] 3 VST 95; [2006]

6 RC 276; [2006] 282 ITR 273; [2006] TIOL 15 and in terms of rule 2A of the Service Tax (Determination of Value) Rules, 2006 and Notification No. 12/2003-ST dated 20th June, 2003.

In terms of sale of software licences, it would be good to bear in mind that, the mode of supply of the software licence could assume great importance, vis-a-vis levy of service, inasmuch as, section 65(105)(zzzze)(v) talks of "acquiring the right to use information technology software supplied electronically" as a taxable service. It would seem that the Government has failed to understand that even customised software can involve transfer of licences. Notwithstanding this, as a matter of abundant caution, I would advise customised software players to use the physical medium like CDs, etc., to transfer licences, rather than the electronic medium.

Customised software having been declared to be "goods", could Central excise duty be levied on customised software? Under the Central excise tariff, Information Technology Software (branded as well as tailor made) is treated as "excisable goods" under Tariff Headings 8523 80 20. However, in terms of Notification No. 6/2006-CE, dated March 1, 2006, "any customised software, that is say, any custom designed software, developed for a specific user of client, other than packaged software or canned software, is exempted from Central excise levy, under Sl. No. 27. Though this notification talks of the exemption being made available to "goods" falling under Central Excise Tariff 8524, it is obvious that the notification has not been amended to reflect the changes in the Central Excise Tariff vis-a-vis Information Technology Software.

Further, in terms of the explanation given to the said Notification No. 6/2006-CE, "Packaged software or canned software" means a software developed to meet the needs of variety of users, and which is intended for sale or capable of being sold, off-the-shelf.

Hence, no Central excise duty can be levied on customised software.Can customised software imports be subjected to customs duty or CVD? Information Technology Software falls under heading 8523 of the Customs Tariff. Though Notification 21/2002-Cus. dated March 1, 2002 talks of a zero rate for import of Information Technology Software for goods falling under Customs Tariff No. 8524, the benefit of zero duty is nevertheless available for import of all software. Thus, there is no customs duty on import of software, whether packaged or

customised. However, CVD of 12 per cent is payable on import branded or packaged or canned software. However, CVD would not be applicable on import of customised software, whether imported in the form of a physical medium like CD or downloaded through web sites, etc.

There is a great tendency in the Customs Department to treat any software imported through the physical medium like CDs as “packaged software”, and levy CVD. This view has always been legally unsustainable and more so, in the light of the honourable Madras High Court decision and software importers would do well to note this.

Is customs duty or CVD payable on import of software licences?

Documents of title conveying the right to use information technology software fall under Customs Tariff No. 4907 00 30 with a 10 per cent duty rate. It is extremely amusing to see that Chapter 49 deals with import of printed books, newspapers, pictures, etc., and the unit of measurement against the Customs Tariff No. 4907 00 30 mentions “Kg”.

However Notification No. 21/2002-Cus., dated March 1, 2002 (Sl. No. 157), as aforesaid, exempts the customs duty levy on import of licences. Moreover, CVD also is not applicable of import of software licences.

Hence, neither customs duty or CVD would be applicable to import of software licences popularly referred to as “paper licences”.

Will the Madras High Court decision help software exporters?

Yes, in a big way. With customised software having been held to be “goods”, software exporters can now try their luck with the Service Tax Department for claiming refunds, on the basis of the legal position that they have exported ”goods”. This point of view is already available given the fact that the Central Excise Tariff treats customised software as “goods” notwithstanding the fact that no excise duty is payable. The department has been taking a view that customised software is a service and since service tax has got levied only from May 16, 2008, customised software services is to be treated as exempted services till May 15, 2008 and consequently, the software exporter would not be entitled to refund of input service taxes paid prior to May 15, 2008. This view would no longer be legally sustainable, in the aftermath of the honourable Madras High Court judgment and software exporters would be entitled to claim refund of input service tax and input duties for the period prior to May 16, 2008. Is TDS applicable under section 194J of the Income-tax Act for transactions involving customised software development contracts?

In the light of the Madras High Court judgment holding that customised software is ”goods”, there would be no justification for the provisions of section 194J to be applied to transactions involving customised software, as no “professional or technical” services within the meaning of section 194J are involved. Hence, in my view, TDS provisions will not be attracted for software development contracts.

Before parting. . .

It is important to clearly understand that, packaged or canned software, which is modified or customised even slightly, would need to be treated as customised software and would consequently be entitled to the benefit of the Madras High Court decision. From a practical perspective, all branded or packaged software do undergo some sort of modification or customisation to suit the needs of the specific customers and would need to be treated as “customised software” for purposes of levy of indirect taxes.

The Madras High Court judgment holding that customised software is “goods”could not have come out at a more appropriate time. The highly respected senior counsel, Mr. C. Natarajan deserves our gratitude for

arguing the Infosys case [2008] 17 VST 256 (Mad); [2008] TIOL 509 (Mad) in the Madras High Court. And, of course, we must also congratulate Infosys for helping develop a precedent on the very contentious issue related to indirect taxation of the software industry.

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