

Madras HC decision in ISODA case could create fresh controversies ... – Sep 24, 2010

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By S Sivakumar, CA

THE Madras High Court, in a landmark decision ([2010-TIOL-620-HC-MAD-ST](#)), has upheld the constitutional validity of Section 65(105)(zzzze) of the Finance Act, 1994, introduced with effect from May 16, 2008 and dealing with the levy of service tax on sale/transfer of software licenses.

The writ filed by the Infotech Software Dealers Association ('ISODA') had raised the following main questions, viz.

++ *Whether software is 'goods'?*

++ *Whether, the transfer/supply of software, in terms of the End User License Agreements entered into by the members of the ISODA would amount to a service, especially in the light of the fact that this transaction is treated as a sale?*

++ *Whether, Parliament has the legislative competency to levy service tax under Section 65(105)(zzzze) of the Finance Act, 1994?*

During the course of the submissions, the Petitioner had submitted that its members are re-selling software products under the three categories, viz. Shrink Wrapped Software, Multiple User Software / Paper License and Internet Downloads.

The Petitioner had submitted that the transactions entered into by its members is only a sale of software being goods and that, no element of service is present and that, only the State Governments are levy tax in terms of Entry 54 of List II of Schedule VII of the Constitution and consequently, the Parliament has no legislative competence to levy service tax on the same transaction under Section 65(105)(zzzze) of the Finance Act, 1994.

The Revenue had contended that the amendment would fall under Entry 97 of List I of Schedule VII of the Constitution of India and that, the challenge to the legislative competency of the Parliament cannot be sustained. The other contentions were that, the standardized software license is available across the shelf or is downloaded from internet, and by itself, it is not a finished product in as much as updates are given by the original manufacturer to the end user for an agreed period. At no stage, does an end user who runs the software becomes the absolute owner of the software. The right to use the software excludes certain rights, particularly the right to modify, right to work on the software and the right to commercially exploit the software and that, each transaction should be considered individually to find out whether it is a sale or service. The Revenue had also contended that the 'service element' is clearly discernible in the case of customized software which is liable for service tax. The Revenue had further contended that the writ petitions are premature, as no action has been taken in terms of the amended provisions of the Finance Act.

Some of the important observations made by the Court are as under:

++ *Goods can be tangible or intangible property and the Indian law does not distinguish between tangible and intangible property.*

++ Software, whether packaged or customized is goods within the meaning of Article 366(12), in terms of the decisions in Apex Court's decisions in the TCS and 20 th Century Finance Corporation case, the Karnataka HC decision in the Antrix Corporation case and the Madras HC decision in the Infosys case and that, the legal position that software is goods is not longer *res integra*.

++ The copyright in a software transaction is protected and always remains the property of the creator/developer and what is sold is the right to use the software. When the sale is with a condition for exclusive use of the software by the customer at the exclusion of others, it gives absolute possession and control to the user of the right to use the software.

++ When the developer does not sell the software (be it packaged or customized) as such, the transaction between the resellers and the end users cannot be a sale of software as such but only the contents of the data stored in the software, which would only amount to a service. When the goods as such are not transferred, the question of deeming sale of goods (transfer of right to use goods) does not arise and the transaction would only be a service and not a sale.

++ If the software is sold through the medium of internet as downloadable, it does not fit into the ambit of IT software of any media and consequently, it is possible to hold that when an access control is given through an internet medium with a username and password and when there is no CD or other storage media for the item, it does not satisfy the requirement of being 'goods'.

++ When the legislative competency of a taxing statute is considered, the nature of transaction and the dominant intention would be relevant.

++ In respect of a transaction which is considered to be a service, no specific entry is prescribed under List I enabling the Parliament to enact law. Entry 97 is a residual entry which empowers the Parliament to enact law in respect of any other matter not enumerated in List II or List III including any tax not mentioned in any of those lists.

Here is the decision of the Madras High Court:

++ The writ petitions were dismissed.

++ Though software is 'goods, the transaction may not amount to a sale in all cases and it may vary depending upon the End User License Agreement. The transaction between the members of ISODA with its customers is not of the sale of the software as such, but only the contents of data stored in the software which would amount to only service.

++ The Parliament has the legislative competency to enact law to include certain services provided or to be provided in terms of 'Information Technology Software Services', in terms of the residuary Entry 97 of List I of Schedule VII. The constitutionally validity of the amended provision cannot be accepted so long as the residuary power is available.

++ *The question as to whether a transaction would amount to sale or service depends upon the individual transaction and on that ground, the vires of a provision cannot be questioned.*

Here are some of the issues that could emerge out of this decision...

++ *The decision has given a new colour to the taxation of the transfer of right to use goods, by States. Look at what the Court says, in Para 31 of the decision:*

“when a transaction takes place between the members of ISODA with its customers, it is not the sale of the software as such, but only the contents of the data stored in the software which would amount to only service. To bring the deemed sale under Article 366(29A)(d) of the Constitution of India, there must be a transfer of right to use any goods and when the goods as such is not transferred, the question of deeming sale of goods does not arise and in that sense, the transaction would be only a service and not a sale”.

It is settled law that, for tax to be levied (by the States) on the transfer of right to use goods, there is no need for the goods to be transferred. Hence, to this extent, the decision would seem to suffer, in as much as, as per this decision, the States would have no power to levy sales tax/VAT on transfer of right to use goods, without transfer of possession of the goods.

++ *The decision would seem to distinguish between transactions entered into by, developers of software products and re-sellers of software products. As we know, most domestic software product players directly sell software licenses to their customers, while, most re-sellers operate in the area of re-sale of imported software licenses. The decision makes an observation that, when the developer does not sell the software (be it packaged or customized) as such, the transaction between the resellers and the end users cannot be a sale of software as such but only the contents of the data stored in the software, which would only amount to a service. Is the Court saying that when Developer transfer the license, the transaction is one of sale, whereas, when the re-seller transfers the license, it is one of service? With due respects to the Court, I am not able to understand this logic. It is perhaps for the first time, that a distinction is sought to be made between selling of a license by a Developer and that, by a re-seller. In practical situations, we see that, there are a lot of similarities between Developers and Re-sellers in terms of after sale services, etc. and hence, such a distinction might add to further controversies.*

++ *The decision does not seem to distinguish between ordinary re-sellers and value added re-sellers. In the former case, all that the ordinary re-sellers does is to simply transfer the license, with all the value added services being provided by the Developer, while, a value added re-seller ('VAR') could provide a lot of services including those related to installation, support, updates, etc. While, there is a case for a VAR to be treated as rendering service, similar reasoning cannot perhaps hold good, for a simple or ordinary re-seller. Most re-sellers trade in software licenses and to band them together with VARs as service providers might not stand further judicial scrutiny.*

++ *Though the decision makes references to Annual Maintenance Contracts, the clear distinction between the sale of a software license and the services provided under the AMC does not seem to have come out clearly, in the decision. There is no dispute on the levy of service tax on AMCs, per se, the same cannot be said of the initial transaction involving the sale of the license.*

++ *The Courts observes that, electronic import of software licenses is a service, as the software (being goods) is not transferred. As we have seen above, the transfer of goods has nothing to do with the transfer of right to use goods. This particular observation could play havoc with the software industry, as most of the transfer of software license happens through the electronic mode. This observation could significantly impact the import of software licenses by Indian resellers and even by Indian corporates, the chunk of which happens through the electronic mode. Is the Court saying that, the physical transfer of software licenses through the physical mode like CDs, etc. is not a service. This distinction does not apply in the case of levy of sales tax/VAT on software licenses, as all transfer or sale of . software licenses are subjected to the levy of sales tax/VAT by the States.*

++ *I feel that the decision has not given adequate reasons, for dismissing the writ petition. Would this then, operate as res judicata ? Will this decision amount to a declaration of the law, within the meaning of Article 141 and consequently, bind the subordinate courts? Many High Courts have held a dismissal of a writ petition, without giving adequate reasons, might not constitute a binding precedent.*

++ *Should the software industry start stopping paying sales tax on sale of software licenses, now that, the High Court has held that, transfer of licenses by re-sellers and electronic transfer of licenses (including by Developers) is a service? I don't think so, Sir. Levy of sales tax/VAT is a different subject and such a levy would not be impacted by this decision.*

++ *Should the software industry be overly concerned, with this decision. I don't think so. The benefit of Notification No. 12/2003 is always available, where under, the re-seller is entitled to exclude the value of the software license for purposes of the service tax levy. I, for one, have always held the view that, the software sector would be better off, taking advantage of Notification No. 12/2003 rather than to get into constitutional issues. Software players would do well to appreciate that while there is a clear provision in terms of Notification No. 12/2003 in terms of exclusion of the value of the sale, for levy of service tax, a similar provision does not exist in most VAT laws, in the case of deemed sales involving transfer of right to use goods. Hence, it would always be advisable to pay VAT/sales tax and claim exemption from levy of service tax, under Notification No. 12/2003.*

++ *In most cases, however, the players are charging both VAT and Service tax and consequently, this decision might be of a lesser impact.*

++ This is yet another case, where the attempt to challenge the constitutional validity of a statutory taxing provision has failed. Is this perhaps, an indication of things to come, in terms of the petitions filed in the Courts, challenging the constitutional validity of several service tax provisions, including those pertaining to the levy of service tax on the Realty sector?

++ Much would depend on the terms and conditions of the agreements entered into by the re-sellers. Perhaps, the re-sellers and even Software Developers would need to take a close re-look at their agreements, taking a cue, perhaps, from this decision.

++ This decision would obviously be, not to the liking of the States and cannot influence the levy of sales tax/VAT by the States on software licenses.