Service Tax on software : Centre poaching in States' territory?
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THE 2008-09 Budget has made a very bold attempt in trying to levy service tax on the software sector. That the Government wants to cover all kinds of activities and services in its tax net is more than evident in the way, it has sought to define the new taxable service, viz. Information Technology Software Service ('ITSS') in the broadest manner possible. But, in its attempt to tax the software sector, it does seem that the Government is stepping into the shoes of the States, vis-à-vis their powers to levy VAT on software.

By the way, whose bright idea was it to call the new taxable service 'Information Technology Software Service', which is supposed to tax services related to customized software. We already have an entry in the Central Excise Tariff under 8523 80 20 which is levied a 12% excise duty and which the Government calls 'packaged software' in its clarificatory circular issued on Feb 29. Now, for the very same name, viz. 'Information Technology Software', we have two different interpretations by the same Government.

For purposes of excise levy, IT Software is considered as 'packaged software' while for purposes of levy of service tax, the very same head is considered as 'customized software'. It couldn't have been worse! I was re-reading the judgment rendered by the Hon'le Supreme Court in the TCS case. In this celebrated case, the Apex Court had held that there is no difference between branded and unbranded software and had held that "in both cases the software can be transmitted, transferred, delivered, stored, possessed and so on. Thus even unbranded software, when it is marketed/sold, may be goods."

The Apex Court had further observed that in the case of unbranded software there were other questions such as "situs of contract of sale and/or whether the contract is a service contract." The Apex Court had pointed out that " in India the test, to determine whether a property is `goods', for purposes of sales tax, is not whether the property is tangible or intangible or incorporeal.

The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed, etc. Admittedly, in the case of software, both canned and uncanned, all of these are possible."

Many of us had thought that at some point of time, going by the TCS judgment [**2004-TIOL-87-SC-CT-LB**], even unbranded /customized software would also have got considered as 'goods' and it was only a question of time before the States realized their powers to levy sales tax/VAT on unbranded software. Before the States could wake up to the potential of taxing
unbranded software (which could be a large revenue earner for the States), it does look that the Centre has completely outsmarted the States with introducing service tax. From a legal point of view, I would think that even unbranded software would more appropriately be treated as 'goods' rather than as 'services' and hence, the Centre's move is bound to result in a lot of litigation.

Further, in its eagerness to levy service tax on this sector, the Centre seems to be trespassing into the rights of the States to levy tax on right to use goods, given to them under Article 366(29A)(d) of the Constitution. Look at the omni-bus way the new service is defined and look specifically at the clause which includes ***right to use IT software*** for commercial exploitation including right to reproduce, distribute and sell, software components for the creation of and inclusion in other IT software products and IT software
supplied electronically. This is clear case of the Centre trying to tax a deemed

sale transaction involving transfer of right to use software being goods, which

is unconstitutional. As such, software product companies, who license out

their software products to their customers are paying VAT and now, the

Budget 2008-09 levies service tax on them, in respect of the same

transaction.

And, I am amused at how the Department has sought to justify the levy of service tax on the software sector. Look at the words that have been used in

the Circular dated Feb 29:

"Software consists of carrier medium such as CD, Floppy and coded data. Softwares are categorized as "normal software" and "specific software". Normalised software is mass market product generally available in packaged form off the shelf in retail outlets. Specific software is tailored to the specific requirement of the customer and is known as customized

software. Packaged software sold off the shelf, being treated as goods". Can this very narrow reasoning justify levy of service tax on such an important sector? For instance, this reasoning completely ignores the element involving transfer of right to use software, which is not packaged software.

As far as my experience of having been associated with the IT industry for over 15 years goes, there is nothing like normal software and abnormal software. The words used by the Supreme Court in the TCS case were both appropriate and logical. One can clearly understand the logic behind the terms 'canned software' and 'un-canned software'. Perhaps, the Department wanted to use words that are very different from what the Apex Court had

used, in order to ensure that its justification for levy of service tax on uncanned / specific / customized software is not questioned, even at the threshold level. Having said that, I can only pity at the plight of the software services industry. On the one hand, it still pays VAT on the branded/canned software which in my opinion, constitutes a very small portion of the overall output of the industry, apart from paying VAT on the value of software licenses. Now, it would have to shell out a hefty 12.36% as service tax on the significant part of its output constituting the unbranded /customized software. I wonder if the software services industry would be better off paying VAT @ 4% even on unbranded software, rather than paying service tax at a much higher rate and as aforesaid, I think, a view to opt to pay VAT on the unbranded/uncanned software can indeed be taken, based on the TCS judgment. Further, I can see that the definitions used by most States for purpose of levy of VAT do cover 'unbranded software' so long as the software is delivered in CDs, Disks, etc. I don't know if it would be a good idea for the software companies to start delivering their outout in CDs and start paying VAT @ 4%.

Now, can we predict the response of the Service Tax Department? The Department would say that what it is taxing is only the 'service' portion and not the 'sale portion'. This logic has indeed been effectively used by the Department over the last few years, in respect of levy of service tax on contentious 'services' like 'Renting of Immovable Property services'. Even the Supreme Court would seem to have endorsed this stand to some extent, in the T N Kalyana Mandapam's case (**2004-TIOL-36-SC-ST)** which I think, encouraged the Government to levy service tax on 'Renting of Immovable Property Services'. But to take this logic forward by defining IT Software Service to include 'right to use software' is perhaps getting straight into the 'goods territory ' and would indeed amount to poaching in the territory reserved for the States. This perhaps, is the first bold attempt by the Centre to tax transactions reserved for the States and this tendency needs to be checked. At this rate, we shouldn't be surprised if the Government introduces a new taxable service under 'Services related to Sale of Goods' at the earliest opportunity.
By the way, I am not against levy of service tax on the software sector.

Writing in TIOL earlier, I had argued for the levy of service tax on this sector.

But, I am worried at the way the Centre is trying to do an overkill on this highly promising and growing industry.

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