# Service tax on customised software-Madras HC delivers a punch – Nov 4, 2008

**Service tax on customised software – Madras HC delivers a punch!**
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**By S Sivakumar, CA**

**THE** Madras High Court has delivered a landmark judgment in a case involving the software major, Infosys Technologies Ltd (**2008-TIOL-509-HC-MAD-CT).** The High Court, on the basis of the Apex Court's decision in the TCS case (**2004-TIOL-87-SC-CT-LB**), has held, interalia, as follows, vis-à-vis customized software:

**Sales tax – if the software whether customized or non-customized 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, wherein it had observed, interalia, that customized software could also be treated as 'goods' has proved to be the ammunition for the latest decision from the Madras HC.**

**The fact remained that the Apex Court's observations on the possibility of customized software also being treated as 'goods', rendered in the context of the TCS case 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 customized software was not a subject matter before the Apex Court in the TCS case. With the latest decision from the Hon'ble Madras High Court holding that customized software is also 'goods', the differentiation between packaged software and customized software wouldbecome 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 TIOL earlier, I had referred to the judgment of the Karnataka High Court in the Inventa case [[*Inventa Software (India) Private Ltd, Bangalore vs. Additional Commissioner of Commercial Taxes, Zone-1, Bangalore and Another 2006(60) Kar.L.J 208 (HC) (DB)*],, wherein it had been held that customized 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 clearly establishes the legal dictum that service tax cannot be levied at all, on customized 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 customized software to service tax is very clear from the CBE&C TRU letter F. No. 334/1/2008-TRU, dated 29-2-2008, relevant extracts of which are reproduced below:

"4.1-2 Software consists of carrier medium such as CD, Floppy and coded data. Softwares are categorized 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 customized software.

4.1-3 Packaged software sold off the shelf, being treated as goods, is leviable to excise duty @ 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 1-3-2008.

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." The Government's intention to 'comprehensively tax the software sector' would seem to have come a cropper, with the Hon'ble Hon'ble Madras HC holding that customized software is 'goods'.

I've tried to analyze the broad implications arising out of this landmark judgment, from the point of levy of central excise, customs, service tax and TDS on customized software transactions.

***Is VAT/Service tax applicable on sale of customized software or sale of software licenses?***

In the aftermath of the decision from the Madras High Court, customized software would attract sales tax or VAT. In some cases, customized 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 case ( **2008-TIOL-04-SC-VAT**), the BSNL Case (**2006-TIOL-15-SC-CT-LB**) and in terms of Rule 2A of the Service tax (Determination of Value) Rules, 2006 and Notification 12/2003-ST dated 20th June, 2003.

In terms of sale of software licenses, it would be good to bear in mind that, the mode of supply of the software license could assume great importance, vis-à-vis levy of service, in as much 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 customized software can involve transfer of licenses. Notwithstanding this, as a matter of abundant caution, I would advise customized software players to use the physical medium like CDs, etc. to transfer licenses, rather than the electronic medium.

***Customized Software having been declared to be 'goods', could central excise duty be levied on customized 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 1-3-2006, "any customized 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-à-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 customized software.

***Can customized software imports be subjected to customs duty or CVD?***

Information Technology Toftware falls under heading 8523 of the Customs Tariff. Though Notification 21/2002-Cus. Dated 1-3-2002 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 customized. However, CVD of 12% is payable on import branded or packaged or canned software. However, CVD would not be applicable on import of customized 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 Hon'ble Madras HC 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% 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 1-3-2002 (Sl.No. 157), as aforesaid, exempts the customs duty levy on import of licenses. Moreover, CVD also is not applicable of import of software licenses.

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

***Will the Madras HC decision help software exporters?***

Yes, in a big way. With customized 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 customized software as 'goods' notwithstanding the fact that no excise duty is payable. The Department has been taking a view that customized software is a service and since service tax has got levied only from May 16, 2008, customized 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 Hon'ble Madras HC 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 customized software development contracts?***

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

**Before parting……**

It is important to clearly understand that, packaged or canned software, which is modified or customized even slightly, would need to be treated as customized software and would consequently be entitled to the benefit of the Madras HC decision. From a practical perspective, all branded or packaged software do undergo some sort ofmodification or customization to suit the needs of the specific customers and would need to be treated as 'customzed software' for purposes of levy of indirect taxes.

The Madras HC judgment holding that customized software is 'goods' could not have come out at a more appropriate time.

**(The author is Director of Bangalore-based S3 Solutions)**