Service tax on transfer of software licenses – TDS fall-outs – July 23, 2008

Service Tax on transfer of software licences: TDS fall-outs!
JULY 23, 2008
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WRITING in TIOL earlier, I had mentioned that the levy of service tax on transfer of software licenses would throw up a pandora's box. The purpose of this piece is to discuss the TDS implications arising thereof.
As per Section 65(105)(zzzze) of the Finance Act 1994 as amended, with effect from May 16, 2008, 'any service provided or to be provided' to any person, by any other person in relation to information technology software for use in the course, or furtherance, of business or commerce, including—

(*i*) development of information technology software,
(*ii*) study, analysis, design and programming of information technology software,
(*iii*) adaptation, upgradation, enhancement, implementation and other similar services related to information technology software,
(*iv*) providing advice, consultancy and assistance on matters related to information technology software, including conducting feasibility studies on implementation of a system, specifications for a database design, guidance and assistance during the start up phase of a new system, specifications to secure a database, advice on proprietary information technology software,
(*v*) acquiring the right to use information technology software for commercial exploitation including right to reproduce, distribute and sell information technology software and right to use software components for the creation of and inclusion in other information technology software products,
(*vi*) acquiring the right to use information technology software supplied electronically;' is a taxable service." Now, acquiring the right to use software is also treated as a sale under the VAT law,
involving a deemed sale. In the state of Karnataka, to which I belong to, software licenses are treated as 'goods' and the transfer of software licenses is subjected to VAT at 4%. Till May 15, 2008, there were no problems in so far as sale/transfer of software licenses is concerned, as only VAT was applicable. Being a sale, there was no question of any tax being deducted at source by the buyer of these licenses, in terms of Section 194J of the Income tax Act, 1961.

In the case of import of software licenses also, being import of goods, there was no requirement for the Indian importer to deduct tax at source, vis-à-vis his payments to the non-residents, in terms of Section 195 of the Income tax Act, not withstanding the Income Tax Department's efforts to levy TDS under Section 195 in certain high profile cases like the one involving Micro Soft. The Microsoft case had been widely reported and commented upon, in TIOL.

Effective May 16, 2008, with service tax being imposed on sale of software licenses, the question of the TDS provisions being attracted under the provisions of the Income tax Act is very real.

Consider these…..

1. As is known, Section 194J of the Income tax Act, after the enactment of the Finance Act, 2007 lays down that, any person, not be ing an individual or a Hindu undivided family, who is responsible for paying to a resident any sum by way of —

(*a*) fees for professional services, or
(*b*) fees for technical services,or
(c) royalty, or

(d) any sum referred to in clause (va) of Section 28.

shall, at the time of credit of such sum to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct an amount equal to ten per cent of such sum as income-tax on income comprised therein.

The Explanation given under Section 194J clarifies that for the purposes of this section, "professional services" means services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or advertising or such other profession as is notified by the Board for the purposes of Section 44AA of this section. The Central Board of Direct Taxes has vide its Notification 3 covered by SO 385(E) dated 4-5-2001 has notified the profession of information technology for purposes of the sub-section.

Given these, it seems clear that transfer of software licenses, now having been notified as a taxable service, would indeed get covered by the provisions of Section 194J and considering the fact that the rate of TDS to be effected is a hefty 10% with effect from June 1, 2007, it is evident that the software product players are in a for big trouble. While, in my opinion, software product players can still manage not to pay service tax on the value of licenses sold or transferred by them which have already suffered VAT or sales tax, by taking the benefit of Notification No. 12/2003-ST dated July 1, 2003 as amended, it is clear that they cannot take a view that sale of software licenses is not a service, *per se* , within the meaning of the service tax law, even though no service tax is paid.
So, this is a big blow for the software product players, vis-à-vis Section 194J of the Income tax Act, considering especially the fact that the TDS rate applicable is 10%.

2. Let's now extend this discussion to the import of software licenses by Indian importers. It is a standard industry practice for Indian Subsidiaries or Branch offices of MNCs or other importers to import software licenses for their own use or for re-sale purposes, either in the physical form or in the electronic form. Section 195 of the Income-Tax Act, 1961 requires that any person responsible for paying a non-resident any sum chargeable under Indian tax law shall deduct income-tax thereon at the rates in force at the time of credit of such sum to the account of the payee or at the time of actual payment thereof, whichever is earlier. With transfer of software licenses being treated as a 'service', it would be very difficult to take a view that the non-residen license holder does not render 'service' in India while transferring the right to use his license, to the Indian party. Consequently, the income arising from the transfer of the software license could be deemed to 'arise or accrue in India', attracting the provisions of Section 195, which require the Indian party to deduct tax at source. As is well known, the Income tax Department had taken a view, even before the introduction of service tax on transfer of software licenses, that the payments effected by the Indian party for import ofsoftware licenses would attract TDS under Section 195 of the Income tax Act. Now, this view will get significantly reinforced, to the detriment of the software license importers.

Surely, this is a bigger blow for the importers of software licenses, as, in most cases, the overseas suppliers want payments to be effected on a 'net of taxes' basis, with the tax element, if any, being contractually borne by the Indian party. The TDS which would work out to about 10%, would, in most cases, add up to the cost of the software license imported as the Indian importer has no means of recovering this amount from either the license supplier or from the Government.

The Budget 2008-09, vis-à-vis import of software licenses would seem to have played havoc on the Indian importer. He has now got to pay service tax @ 12.36% as the importer of the taxable services and has also got to effect TDS @ 10%.

3. By the way, in an interesting case (**2006-TIOL-08-ARA-IT**), the Advance Ruling Authority had held that the Indian company, Headstart Business Solutions (P) Ltd which had entered into a Solution Provider Agreement

with Microsoft Regional Sales Corporation, Singapore, in July 2005 for supplying packaged business software solutions to Indian customers was liable to effect TDS under Section 195 of the Income tax Act. In this case, the product was meant to be delivered in a physical form through a compact disc accompanied by a software licence key which was to be delivered electronically through e-mail over the Net.
The software licence key was to bear the name of the client to whom the software was to be delivered.

In my opinion, import of software thro' the licensing route, either in the form of CDs thro' the electronic medium, would require the Indian importer to pay both service tax and TDS.

In conclusion, it would then seem that the extended definition of Information Technology Software Service to include even transfer of software licenses would indeed result in more robust TDS collections for the Government, under Sections 194J and 195 of the Income tax Act, 1961.

A significant unintended revenue for the Government, perhaps. As we had expected, several unintended issues are coming out of the proverbial Pandora's box to haunt the software industry, which is already reeling under a slowdown.

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