

## **INFORMATION TECHNOLOGY SOFTWARE SERVICE**

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The Finance Bill, 2008 (the “**Bill**”) seeks to levy service tax on the Information Technology Software Service (“**ITSS**”) by inserting Section 65(105) (zzzze) in the Finance Act, 1994 (the “**Act**”). The scope of ITSS is defined in the Bill under the proposed section 65(105) (zzzze) of the Act. Provision of any service by any person to any 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 startup 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.

### **What is IT Software**

Proposed Section 65 (53a) of the Act defines information technology software as any representation of instructions, data, sound or image, including source code and object code, recorded in a machine readable form, and capable of being manipulated or providing interactivity to a user, by means of a computer or an automatic data processing machine (“**ADP**”) or any other device or equipment.

### **Movie or music CD/DVD**

Market is flooded with music/movie CDs, VCDs and DVDs. These media have film, picture and music digitally recorded thereon and can be played on computer and ADPs. Although, data, sound or image is recorded in a machine readable form, they are not capable of being manipulated or providing interactivity to a user. Therefore, music/film recorded media are not IT Software.

### **Multi-media CD ROM**

In the case of **Padmini Polymers Ltd. v Commissioner of Customs [2006 (201) E.L.T. 623 (Tri)]**, the Hon'ble Tribunal held that Cinderella story and USA Cook Book in CD ROM is not IT Software as there was no evidence on record to show that the user can manipulate the data while the programme is running in order to locate a particular information. A PC game CD is IT Software as it provides interactivity to a user. Digital dictionary like MSN Encarta, Britannia Encyclopedia etc are also IT Software as information can be searched by manipulating data.

In the case of **Commissioner of Customs v. Pentamedia Graphics Ltd [2006 (198) E.L.T. 164 (S.C.)]**, the Hon'ble Supreme Court held that motion capture animation files are computer software recorded in a machine readable form and capable of being manipulated by means of an ADP. Merely because motion capture animation files require another software known as 'soft image' to get final results, it does not detract goods from being software.

### **Coverage of ITSS**

The list of activities/services forming part of ITSS is comprehensive. It covers development, study, analysis, design, programming, adaptation, upgradation, enhancement and implementation of software. Advice, consultancy and assistance for software provided by any person is also included herein. It also cover right to use software supplied electronically or otherwise.

### **Coverage under some other taxable services**

Some facets of the IT Software are also covered under some other taxable services like, Consulting engineer's service [section 65(105)(g)], Management or business consultant's service [section 65(65)], Management, maintenance or repair service [section 65(64)], Business support service [section 65(105)(zzzq)], Business auxiliary service [section 65(19)], Technical testing and analysis service [section 65(105)(zzh)] and Technical inspection and certification service [section 65(105)(zzi)].

### **Board Clarification**

Board vide D.O. F. No.334/1/2008-TRU dated 29 February 2008 has clarified that software consists of carrier medium such as CD, Floppy and coded data. Software are categorized as "normal software" and "specific software". Normalized 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, is leviable to excise duty @ 8%. Software and upgrades of software are also supplied electronically, known as digital delivery. Taxation is to be neutral and should not depend on the forms of delivery. Such supply of IT software electronically shall be covered within the scope of the proposed service.

Therefore, from the Board clarification, it appears that intention of ITSS is to levy service tax, *interalia*, on (i) customised software (ii) transfer of right to use Software and (iii) electronically transmitted software.

### **Whether customised software is goods or service**

In the case of **Tata Consultancy Services v. State of Andhra Pradesh [2004 (178) E.L.T. 22 (S.C.)]**, constitution bench of the Hon'ble Supreme Court held that sale by licensee of canned software being capable of abstraction, consumption, use, transmission, transfer, delivery, storage, possession etc. is liable to sales tax. The apex court further observed that there is no distinction between branded and unbranded software. In both cases, the software is capable of being abstracted, consumed and used. In both cases the software can be transmitted, transferred, delivered, stored, possessed etc. Thus even unbranded software, when it is marketed / sold, may be goods. However, the apex court did not give any final opinion thereon because in case of unbranded software other questions like situs of contract of sale and/or whether the contract is a service contract will arise. Therefore, the question whether customised software is a goods or service was left open.

In the case of **Builders Association of India v. Union of India [AIR 1989 SC (076) 1371]**, five member bench of the Hon'ble Supreme Court held that the fact that the goods were specially manufactured and designed for a particular purpose cannot be held to deprive them of the character of goods. Therefore, customisation of goods does not deprive their character as goods.

Whether customised software is a goods or service will essentially depend on terms of the contract. In the case of **State of Madras v. Gannon Dunkerley & Co. Ltd. [AIR 1958 SC 560]**, the Supreme Court has held that there had to be three essential components to constitute a transaction of sale, namely

- (i) an agreement to transfer title,
- (ii) supported by consideration, and
- (iii) an actual transfer of title in the goods

Further, in the case of **Bharat Sanchar Nigam Ltd v. Union of India [2006 (002) STR 0161 (SC)]**, the Apex Court held that the seller and the purchaser should have *ad idem* as to the subject matter of sale or purchase to be considered as sale of goods under Sale of Goods Act. If as per terms and condition of the Agreement, the sole intension of the party and matter of the contract is for providing service, then the transaction cannot be considered as sale of goods under Sale of Goods Act but will be subject matter of service tax and vice versa.

Therefore, a development and sale of customised software to a specific user may not always be a contract of service. If it is found to be sale of goods, it will be liable for VAT under the State VAT laws and not service tax under the Act.

### **Transfer of right to use of software**

Article 366(29A)(d) of the Constitution empowers state to levy VAT on the transfer of the right to use the goods. In the case of **Bharat Sanchar Nigam Ltd**, the Apex Court held that States are not allowed to entrench upon the Union List and tax services by including the cost of such service in the value of the goods. For the same reason, the Centre cannot include the value of the goods in the cost of the service as was held in **Gujarat Ambuja Cements Ltd. v. UOI [(2005) 4 SCC 214]**. The Court further held that mutual exclusivity which has been reflected in Article 246(1) of the Constitution means that taxing entries must be construed so as to maintain exclusivity. In the case of **Imagic Creative Pvt. Ltd. v Commissioner of Commercial Taxes in Appeal (civil) No. 252 of 2008**, the Apex Court again reiterated that payments of service tax as also the VAT are mutually exclusive.

In the case of Tata Consultancy Services, the Apex Court held that goods includes both tangible and intangible movable properties, materials, commodities and articles and also corporeal and incorporeal materials. Therefore, transfer of right to use software, being intangible movable intellectual property, is exigible to VAT. Only a few transactions may not be exigible to VAT and therefore, may be subjected to service tax.

### **Electronic transmission of software**

Software can be supplied either in a media (like CD, DVD, Floppy diskette, Cassettes etc.) or can be transmitted through internet, LAN or telephone lines. The Bill seeks to levy service tax on acquiring the right to use information technology software supplied electronically. As stated above, even intangibles are goods, and therefore payments for right to use information technology software supplied electronically may be subject to VAT. However, States can levy VAT only if the transaction takes place within the State and not inter-state or in the course of import. If the transaction is inter-state, it may be subject to CST.

Electronic transmission of software is most interesting aspect in this discussion. It throws open a large number of possibilities. Generally, software is transmitted through one computer to other wherein intermediates like server and internet also play a vital part. Many a times, software is hosted in a server from where it is downloaded by the users. A few of such situations are indicated below:

- i Vendor and user, both are in the same state > software is transmitted from the vendor's computer to the user's computer
- ii Vendor and user are in the different state > software is transmitted from the vendor's computer to the user's computer
- iii Vendor and user, both are in the same state and the software is hosted in a server at some other state > transmitted from the server to the user's computer

- iv Vendor and user, both are in the same state and the software is hosted in a server at foreign country > transmitted from the foreign server to the user's computer
- v Vendor and user, both are in the different state and the software is hosted in a server at third state > transmitted from the third state server to the user's computer
- vi Vendor and user, both are in the different state and the software is hosted in a server at foreign country > transmitted from the server to the user's computer
- vii Vendor is a foreign person and user is a India resident and the software is hosted in a state in India
- viii Vendor is a foreign person and user is a India resident and the software is hosted outside India
- viii Transaction in a virtual world where identity of vendor/user is not known

Any guess as to how the transaction will be taxed by VAT and service tax authorities? I am clueless. Sale of goods or transfer of right to use in the course of import is not subject to VAT or CST. It is easier to discuss situation where the vendor is a foreign person, user is resident in India and the software is hosted outside India.

### **Customs Duty**

As per Section 12 of the Customs Act, 1962 duties of customs are levied on goods imported into India. As per Section 2(22) of the Customs Act 'goods' includes vessels, aircraft, vehicles, stores, baggage, currency, negotiable instruments and any other kind of movable property. To be a movable property, software should be recorded in a media. As per Section 2(23) of the Customs Act, 'import', with its grammatical variations and cognate expressions, means bringing into India from a place outside India. Therefore, custom duty is levied on the software recorded in a media brought from abroad. Electronic transmission of software from outside India to India is not import of goods. The CESTAT in the case of **Digital Equipment (India) Ltd vs Commissioner of Customs [2001 (135) ELT 062 (T)]**, has held that acquisition of software transmitted through E-mail or downloaded from the internet is not import of goods and therefore not liable to customs duty.

### **Import of Service**

In terms of Section 66A of the Act read with Taxation of Services (Provided From Outside India and Received in India) Rules, 2006, where any taxable service is provided by a person having business or fixed establishment or permanent address or usual place of residence outside India, and received by a person having his place of business, fixed establishment, permanent address or usual place of residence, in India, then such service shall, be taxable service, and such taxable service shall be treated as if the recipient had himself provided the service in India. In terms of Section 68(2), certain categories of persons liable to pay service tax are specified the Service Tax Rules, 1994. Further, in the In terms of Rule 2(d)(iv) of the Service Tax Rules, in relation to any taxable service

provided or to be provided by any person from a country other than India and received by any person in India under section 66A of the Act, the recipient of such service is liable to pay service tax.

Therefore, service tax on the transmission of software from a server hosted outside India and provided by a foreign person to an Indian resident will be payable by the Indian resident. In other words, there will be service tax on electronic transmission of software in India.

### **WTO Moratorium**

In 1998, WTO member countries agreed for a moratorium on imposition of customs duties on electronically delivered software. The issue is hotly debated worldwide and global community has failed to arrive at consensus. Sixth WTO Ministerial Conference, Hong Kong in declaration dated 18 December 2005 declared that:

*“We take note of the reports from the General Council and subsidiary bodies on the Work Programme on Electronic Commerce, and that the examination of issues under the Work Programme is not yet complete. We agree to reinvigorate that work, including the development-related issues under the Work Programme and discussions on the trade treatment, inter alia, of electronically delivered software. We agree to maintain the current institutional arrangements for the Work Programme. **We declare that Members will maintain their current practice of not imposing customs duties on electronic transmissions until our next Session.**”*

India is an active participant in the WTO discussion and was also a party to the aforesaid declaration. In fact, Economic Survey, 2007-08 (page 159) recognizes this fact and says:

*“India’s position on non-imposition of customs duty on electronic transmission has been that given the inherent advantage India has in e-commerce, it can maintain a liberal regime on electronic transmissions at present. However, this must not preclude its options for possible methods of taxation since the future course of growth in ecommerce is impossible to visualize. As and when viable methods of levying duties and taxes can be found, there should be freedom to impose customs duties, excise duties, sales tax, etc., on electronic transmissions.”*

Although policy makers recognizes the fact that there should be liberal regime on electronic transmission of software across the boarder and expect other countries to refrain from imposing tax as stated in WTO moratorium, service tax is proposed to be imposed on import of software transmitted electronically. Although, WTO moratorium bars member countries from imposing customs duty and there is no bar on tax on consumption but certainly, world community is not going to take this step kindly and there is going to be bad spotlight on India.

## **Threshold Limit**

Notification No. 6/2005-S.T. dated 1-3-2005 exempts small service providers from payment of service tax. During financial year 2007-08, threshold limit was 8 Lakhs and during 2008-09, it is proposed to be Rs 10 Lakhs. However, In terms of proviso (ii) of the notification, where service tax is paid by a person and in a manner as specified under sub-section (2) of section 68 of the said Finance Act read with Service Tax Rules, 1994, the exemption is not available. Therefore, there is no threshold exemption of Rs 8/10 Lakhs when the service recipient is required to pay service tax in reverse charge system. Hence, every person who downloads software from the internet is required to obtain service tax registration and pay service tax irrespective of the amount spent for acquisition of the software.

## **Classification of service**

In terms of Section 65A(2) of the Act, when for any reason, a taxable service is, *prima facie*, classifiable under two or more sub-clauses of clause (105) of section 65, classification shall be effected as follows :-

- (a) the sub-clause which provides the most specific description shall be preferred to sub-clauses providing a more general description;
- (b) composite services consisting of a combination of different services which cannot be classified in the manner specified in clause (a), shall be classified as if they consisted of a service which gives them their essential character, in so far as this criterion is applicable;
- (c) when a service cannot be classified in the manner specified in clause (a) or clause (b), it shall be classified under the sub-clause which occurs first among the sub-clauses which equally merit consideration.

Some of the services rendered in relation to IT Software are classifiable at some other description as stated above. If a qualified engineer provides an advice, consultancy and assistance on matters related to information technology software, it will be classifiable under the Consulting engineers service and not under ITSS. Procurement and management of information technology resources is classifiable under Management or business consultant's service. Maintenance of software, both packaged and customized is taxable under Management, maintenance or repair service. Multiplicity of classification with overlapping scope is bound to create confusion in the minds of taxpayers and tax collectors.

## **Conclusion**

An efficient tax regime should be simple, transparent and easy to administer. The taxpayer should also know whether he is liable to pay VAT or service tax as both are mutually exclusive. Further, tax demanded under one classification cannot be confirmed under a different classification. It appears that ITSS as a dispute free taxable service is miles to go.