Indirect Tax applicability to software industry

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In this article the paper writers have sought to examine the various kinds of software transactions and indirect taxes implications. Inspite of earning billions in CFE, the bane of the software industry in India in addition to no / part or delayed refund, has been imposition of multiple levies which has lead to double taxation especially with VAT and service tax being levied on same base amount. However all transactions are not liable for both ST and VAT.

Background

The aspect of ascertaining the applicability of indirect taxes under Central Excise, Customs, VAT or Service Tax is important. Before getting into the aspect of ascertaining the taxation, one has to firstly understand whether software is goods?

The Hon'ble Supreme Court in Tata Consultancy Services Vs State Of Andhra Pradesh 2004 (178) ELT 0022 (S.C.), held that Computer software **in canned form or of the shelf software does** have the attributes of having utility, capable of being bought and sold, capable of being transmitted, transferred, delivered, stored and possessed, which are the attributes of goods and thus it is goods is in its marketable form. From the said decision it is now well settled that **'software' is goods**. In the case of Infosys Technologies Ltd., Vs. CCE 2009 (233) ELT 56 (Mad), held that even customized software is goods.

The High Court in ISODA case(2010 (020) STR 0289 Mad)upheld the constitutional validity of service tax on Information technology software service stating that not in all the cases of software related transaction there is sale. There may be also service element, what is intended to be taxed on the services involved in the transaction. It further said whether the transaction to be treated as Sale or Service has to be decided on a case to case basis based on terms and conditions between parties.

Central Excise and Customs on Software

Software on a CD or any other media is covered under the Central Excise Tariff Act, under the chapter heading (hereinafter referred as heading) 8523. The Chapter Notes to Chapter 85 read with the section 2(f)(ii) of the Central Excise Act, the activity of recording any phenomenon on a media would be deemed manufacture. Even reproduction of developed software into number of CDs would also be considered as deemed activity of manufacture.

Excise duty is applicable on packaged software at 12.5%. Customised software is exempted from excise duty vide notification 12/12-CE.

When software is imported on a media it is treated as goods and import duties applicable to same. BCD is free, CVD[equal to excise duty on like goods manufactured in India] is 12.5% for packaged software and nil for customized software.SAD is nil for Information technology software, other than that on floppy disc or cartridge tape vide notification 21/12-Cus.When BCD and CVD is nil, SAD is also nil vide notification 21/12-Cus for customized software. SAD is also nil for all pre-packaged goods intended for retail sale in relation to which it is required, under the provisions of the Legal Metrology Act, 2009 or the rules made thereunder or under any other law for the time being in force, to declare on the package thereof the retail sale price of such article. If it is required to declare RSP onpre-packaged goods[on software] intended for retail sale as per Legal Metrology Act, then SAD is exempted.

Service Tax

Under negative list based taxation, service tax is levied on all services other than those mentioned in negative list or a subject matter of exemption.The definition of service covers any activity done by one person to another for consideration. The term service is defined to include declared services. This has covered specified services relating to information technology software. Also covers temporary transfer of any intellectual property right as a service. Service tax rate is 12.36%.

Levy of VAT on software

In order to constitute a sale liable to VAT, tax there should be transfer of property in goods from one person to another for cash, deferred payment or other valuable consideration. By valuable consideration we mean something which could be measured in terms of money. The VAT is imposed as per rates set out in Section 4(1)(a) and (b) given in Schedules to Act.

On a perusal of schedule 3 of KVAT Act 2003, it sets out Exim scrips, ……..**copyrights**, patents and the like including software licenses by whatever name called. The applicable rate is 5.5%.

VAT vs Service tax on software

Where there is a program sold on media **without reservation** [source code etc also transferred] then it is plain and simple sale with no service being involved. Not liable to service tax. Once software is goods, transfer of right to use the same for consideration should be subject matter of VAT going by Article 366(29A) of Constitution of India.

The deemed sale entry covers transfer of right to use goods. In many cases the copyright or the intellectual property right relating to the software sold continue to vest with the seller. This does not affect the nature of the transaction from being a sale for the purposes of the VAT Act, though it should.

The same transaction could also be taxable to service tax, under another declared services entry of transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods if the developer is merely permitting to use the software [which is goods] subject to conditions and restrictions as to its usage/replication imposed in this regards.

Where there is no involvement of transfer of right to use, then there may not be transfer of title in goods nor a deemed sale of goods. 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 the transaction would be only a service and not a sale.

There is a finer distinction between the applicability of VAT and service tax. In the case of VAT there would be “transfer of Right to Use the Goods“. Whereas under the service Tax, what is levied is “temporary transfer/enjoyment of the goods”.

Again taking conservative view most people in software industry, are charging both VAT and Service Tax usually where software is given by means of a license.

Indirect Taxes on Models prevalent in software industry

The industry has the following types of transactions:

a. **Canned or off the shelf software:** Development, upgradation, etc., done before release is for oneself. This can be construed only as sale of goods liable to sales tax. Where a master is copied, the duplication has been considered to be manufacture. Therefore liable for excise duty @ 12.5%[if off the shelf packaged software]. If imported same impact.

b. **Customised Software**: When one sells customised software to the customer as per their needs it is a sale liable to VAT. It is also subjected to service tax. Not liable to Excise duty. If software developed by seller then not liable for service tax also as it is a "literary work"".

c. **Electronic download**: The software are not given on media CD or in hard form, instead it is permitted to be downloaded from internet and license is provided separately to use it, here it is considered as service. The VAT authorities are contending that 'right to use goods' comes within the ambit of deemed sale definition, taxed under sales tax. At present there is double taxation, with both VAT/sales tax and Service Tax being charged.

d. **Sale of licenses**: This is a deemed sale of right to use the software liable for sales tax. It could also be liable to service tax.

e. **Customisation on software owned by customer:** This is working on the program owned by the client where the property of the developed program is always the property of the customer. VAT/ Sales tax is not payable on same. Service tax liable.

f. **Software developed as per customer specification**: The customer gives specifications and company develops to the needs of the customer. Since the company does not retain rights and completely given to the customer with source and object codes, there is no service, it is only sale of goods subject matter of only sales tax.

g. **Software works contract- Option 1- IPR with Developer:** Customer is intending to develop the software wherein they seek services of software company to develop on continuous consultation with the customer, where the original software belongs to the customer. In this process the Intellectual Property of the final product may go to the customer, but the intermediate programs would be that of software company, which

can be used by them for other developments. This involves providing of both services as well as goods (as firstly the property in software developed comes to developmentcompany and later transfers to that extent to the customer. In addition to this they also provide services of incorporation, implementation etc.,). This could be considered as works contract under sales tax and service tax department is treating it as service. Both sales tax and service tax is being paid by the industry in this case as well.

h. **Option- 2- IPR with Customer:** Similar to the previous one, except that all the intellectual property in all the work would belong to the customers and in no part it would become the property of the service provider. As and when codes generated they belong to the customer. This is merely a service of software development provided to the customer and therefore it is subject matter of only service tax. However it should be appropriately supported by documents to mitigate the local VAT authorities queries.

i. **Software Consultancy:** The customer engages professional as consultants, developers who would work only under supervision or control of the customer with no responsibility on them to deliver any specific software work. It is only service liable to service tax.

IDT implications of various revenue models

1. **Access of Software on Subscription basis**: When access to software is given, without any license to use, only liable to service tax under Information technology software services and there may be no VAT liability.

2. **Software patches**: As a part of upgradation or AMC, any further software patches are provided, then as also involving sale of goods by sales tax authorities. Therefore the same would be subject matter of sales tax as well in addition to service tax.

3. **Implementation of software/installation:** There is no transfer of property in goods nor a right to use goods. Merely an implementation service, subject matter of only service tax.

4. **Testing:** It is a pure service, as there is no transfer of right to use the software. Liable only to service tax.

5. **Debugging:** Only if there is a transfer of software, it is liable to sales tax. Debugging not involving additional software addition would be liable to only to Service tax.

6. **Maintenance of software:** This maybe a works contract or a service contract. If works contract liable for both. If pure service contract, it is not liable to sales tax.

7. **Software on server / cloud**: This is a new methodology where the control and possession of the data/ programs being accessed remain with the service provider [ISP] which maybe hosted on the server of the vendor in or outside India. The contract allows the customer to access the site and enjoy certain privileges. This would be liable only to service tax.

8. **Manpower supply within India or outside India:** Software engineers with specific skills/ qualification provided within India, it is liable to service tax. When sent abroad, where they are employed by foreign companies and they perform software related services there. As there is no transfer of property in goods[software] in both scenarios, it is not liable to sales tax.Service tax may also not be applicable, as services are done outside India.

9. **Software Development outside India:** The Indian company gets software development contract. Its engineers go abroad to render services on the foreign clients' site. There is no VAT/CST or service tax liability as the activities are done completely outside India.

The above models are merely indicative and there could be many more permutations and combinations. The indirect tax implications may need to be examined separately, depending on the activities done as per agreement between the parties.

Conclusion

In this article the paper writer has sought to examine the applicability of various taxes to software along with possible exemptions/exclusions. There is overlap between various levies and in absence of any clarity, the assessee may continue to pay multiple taxes, which would be finally borne by the end customer. It is hoped that under GST law, there would be some mechanism to ensure that taxes are not paid on more than 100% of base amount charged towards software by assessee.