So soft on software

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The software industry is plagued by multiple levies. The Constitution bench of the Hon'ble Supreme Court has held in TCS case {2014(178) ELT 22 SC} that software loaded in a medium is "goods". Once it is goods, the manufacture of it would attract Excise duty and sale thereof would attract VAT / CST. Further, packaged software falling under chapter 8523 8020 is also included in the Third Schedule to the Central Excise Act, 1944 (CE Act) and any activities such as packing or repacking of such goods in a unit container or labelling or re-labelling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer carried out on them would amount to manufacture. Further the same is also notified under Section 4 A of the CE Act, for the purpose of levy of excise duty based on their Retail Sale Price (RSP), if there is a requirement to affix RSP on the said packaged software, as per the provisions of the Legal Metrology Act, 2009 / LM Rules (LM Act / Rules). If there is no such requirement, duty of excise / CVD has to be paid on the basis of transaction value, under Section 4 of the CE Act.

Many a times, the software is not sold absolutely but is only licensed for use with lot of restrictions. In such case, there is no effective transfer of right to use and hence the transaction would not amount to sale, but would be a "service", attracting service tax. In this connection, it is relevant to refer to the following activities which are declared as service under Section 66 E of the Finance Act, 1994.

> *(c) temporary transfer or permitting the use or enjoyment of any intellectual property right;*
>
> *(d) development, design, programming, customisation, adaptation, upgradation, enhancement, implementation of information technology software;*
>
> *(f) transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods;*

Though it is a settled position of law that both sales and service are mutually exclusive, the border line between them is always thin and both Central Government and State Government are always pitted against each other, in claiming the transaction as a service or as a sale, respectively. Though there is no explicit constitutional mutual exclusivity between levy of excise duty and service tax, such mutual exclusivity is recognised statutorily at many places (eg. Keeping an activity amounting to manufacture under negative list, providing for exemption from payment of service tax for job workers, if ultimately excise duty is paid, etc).

Once software is recognised as goods, the same is leviable to Excise duty, when manufactured in India and removed. When such removal is not by way of sale, but by way of licencing, the same shall also attract the levy of service tax. In this connection it is relevant to refer to the following clarifications contained in the Education Guide, when negative list based service tax levy was introduced from 01.07.2012.

6.3 Temporary transfer or permitting the use or enjoyment of any intellectual property right

6.3.1 What is the scope of the term 'intellectual property right'?

'Intellectual property right' has not been defined In the Act. The phrase has to be understood as in normal trade parlance as per which intellectual property right includes the following :-

- *Copyright*
- *Patents*
- *Trademarks*
- *Designs*
- *Any other similar right to an intangible property*

6.3.2 Is the IPR required to be registered in India? Would the temporary transfer of a patent registered in a country outside India also be covered under this entry?

Since there is no condition regarding the law under which an intellectual right should be registered, temporary transfer of a patent registered outside India would also be covered in this entry. However, it will become taxable only if the place of provision of service of temporary transfer of intellectual property right is in taxable territory.

6.4 Development, design, programming, customization, adaptation, up gradation, enhancement, implementation of information technology software

The term 'information technology software' has been defined in section 65B of the Act 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 or any other device or equipment'.

6.4.1 Would sale of pre-packaged or canned software be included in this entry?

No. It is a settled position of law that pre-packaged or canned software which is put on a media is in the nature of goods [Supreme Court judgment in case of Tata Consultancy Services v. State of Andhra Pradesh [2002 (178) E.L.T. 22 (S.C.) refers]. Sale of pre-packaged or canned software is, therefore, in the nature of sale of goods and is not covered in this entry.

6.4.2 Is on site development of software covered under this entry?

Yes. On site development of software is covered under the category of development of information technology software.

6.4.3 Would providing advice, consultancy and assistance on matters relating to information technology software be chargeable to service tax?

These services may not be covered under the declared list entry relating to information technology software. However, such activities when carried out by a person for another for consideration would fall within the definition of service and hence chargeable to service tax if other requirements of taxability are satisfied.

6.4.4 Would providing a license to use pre-packaged software be a taxable service?

The following position of law needs to be appreciated to determine whether a license to use pre packaged software would be goods -

- *As held by the Hon'ble Supreme Court in the case of Tata Consultancy Services v. State of Andhra Pradesh [2002 (178) E.L.T. 22 (S.C.)] pre-packaged software or canned software or shrink wrapped software put on a media like is goods. Relevant portion of para 24 of the judgment is reproduced below-*

"A software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or canvas (in case of painting) or computer discs or cassettes, and marketed would become "goods". We see no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media i.e. the paper or cassette or disc or CD. Thus a transaction sale of computer software is clearly a sale of "goods" within the meaning of the term as defined in the said Act. The term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed etc. The software programmes have all these attributes."

Therefore, in case a pre-packaged or canned software or shrink wrapped software is sold then the transaction would be in the nature of sale of goods and no service tax would be leviable.

- *The judgment of the Supreme Court in Tata Consultancy Service case is applicable in case the pre-packaged software is put on a media before sale. In such a case the transaction will go out of the ambit of definition of service as it would be an activity involving only a transfer of title in goods.*

- *As per the definition of 'service' as contained in clause (44) of section 65(B) only those transactions are outside the ambit of service which constitute only a transfer of title in goods or such transfers which are deemed to be a sale within the meaning of Clause 29(A) of article 366 of the Constitution. The relevant category of deemed sale is transfer of right to use goods contained in sub-clause (d) of clause (29A) of the Constitution.*

- *'Transfer of right to use goods' is deemed to be a sale under Article 366(29A) of the Constitution of India and transfer of goods by way of hiring, leasing, licensing or any such manner without transfer of right to use such goods is a declared service under clause (f) of section 66E.*

- *Transfer of right to use goods is a well-recognized constitutional and legal concept. Every transfer of goods on lease, license or hiring basis does not result in transfer of right to use goods. For understanding the concept of transfer of right to use please refer to point no 6.6.1.*

- *A license to use software which does not involve the transfer of 'right to use' would neither be a transfer of title in goods nor a deemed sale of goods. Such an activity would fall in the ambit of definition of 'service' and also in the declared service category specified in clause (f) of section 66E.*

- *Therefore, if a pre-packaged or canned software is not sold but is transferred under a license to use such software, the terms and conditions of the license to use such software would have to be seen to come to the conclusion as to whether the license to use packaged software involves transfer of 'right to use' such software in the sense the phrase has been used in sub-clause (d) of article 366(29A) of the Constitution. (See point no 5.6.1).*

- *In case a license to use pre-packaged software imposes restrictions on the usage of such licenses, which interfere with the free enjoyment of the software, then such license would not result in transfer of right to use the software within the meaning of Clause 29(A) of Article 366 of the Constitution. Every condition imposed in this regard will not make it liable to service tax. The condition should be such as restraints the right to free enjoyment on the same lines as a person who has otherwise purchased goods is able to have. Any restriction of this kind on transfer of software so licensed would tantamount to such a restraint.*

- *Whether the license to use software is in the paper form or in electronic form makes no material difference to the transaction.*

- *However, the manner in which software is transferred makes material difference to the nature of transaction. If the software is put on the media like computer disks or even embedded on a computer before the sale the same would be treated as goods. If software or any programme contained is delivered online or is down loaded on the internet the same would not be treated as goods as software as the judgment of the Supreme Court in Tata Consultancy Service case is applicable only in case the pre-packaged software is put on a media before sale.*

- *Delivery of content online would also not amount to a transaction in goods as the content has not been put on a media before sale. Delivery of content online for consideration would, therefore, amount to provision of service.*

6.4.5 In case contract is given for customized development of software and the customized software so developed is delivered to the client on media like a CD then would the transaction fall in this declared entry or would it be covered by the TCS Judgment?

In such a case although the software is finally delivered in the form of goods, since the contract is essentially for design and development of software it would fall in the declared list entry. Such a transaction would be in the nature of composite transaction involving an element of provision of service, in as much as the contract is for design and development of software and also an element of transfer of title in goods, in as much as the property in CD containing the developed software is transferred to the client. However, the CD remains only a media to transmit or deliver the outcome of which is essentially and pre-dominantly a contract of service. Therefore, such a transaction would not be excluded from the ambit of the definition of 'service' as the transaction does not involve 'only' transfer of title in goods and dominant nature of the transaction is that of provision of service.

The following points emerge from the above clarifications.

- Pre-packaged software is goods and hence leviable to Excise duty (Customs duties, if imported), subject to exemptions available if any (At present packaged software is included in the Third Schedule to the CE Act and liable to duty of excise on the basis of their Retail Sale Price, as per Section 4 A of the said Act).
- When such packaged software is sold, appropriate VAT / CST is payable and when it is only licenced, service tax is payable.
- Development of a customised software is a service.
- Customised software, loaded in a medium is also goods and hence liable to Excise duty, subject to exemptions, if any. (At present exempted from excise duty vide S.No. 266 of Notification 12/2012 CE).

In the current budget, sincere attempt has been made to avoid the simultaneous levy of Excise duty (CVD in case of imports) and Service Tax on software.

Vide Notification 11/2016 ST DT. 01.03.2016 it has been provided that when Excise duty is paid on domestically manufactured software, on the basis their RSP, as per Section 4 A of the CE Act, 1944 or in case of imported software, CVD is paid on the basis their RSP, as per Section 4 A of the CE Act, 1944, then any licencing of such software would be exempted from payment of service tax. Prior to this notification, when packaged software is licenced (without making the transaction as a sale), both excise duty / CVD on the one hand and Service Tax on the other hand was payable. Though it was open to the parties to segregate the value of goods involved and the value of service involved, all stakeholders were very reluctant to indulge in any such value bifurcation, for fear of departmental questioning. Now, to their big relief, the above exemption from service tax has been introduced.

It is not in all the cases, Excise Duty / CVD is paid on the basis of RSP in case of packaged software. Section 4 A will come into play, only where there is a requirement to affix RSP on the packages, as per the LM Act / Rules, which also provides various exemptions from affixing of RSP. For example if the packaged software is sold to an institutional consumer or industrial consumer (which terms are defined in the LM Act / Rules), there is no requirement to affix RSP and duty of excise / CVD in such cases have to be paid on the basis of transaction value, as per Section 4 of the CE Act, 1944.

Notification 14/2011 CE DT. 01.03.2011 has provided for exemption from payment of excise duty on packaged software if such packaged software is not required to be affixed with RSP under LM Act / Rules, on a value, attributable to consideration for licensing such packaged software. Similar exemption was available for CVD also, under Notification 25/2011 Cus. 01.03.2011. These

exemptions were applicable only for packaged software. In other words, when packaged software is liable to excise duty / CVD under section 4 of the CE Act, the value could be split between the value for goods (on which Excise duty / CVD is applicable) and value for service (on which service tax is applicable).

Now, this facility has also been extended to customised software also, vide notification 11/2016 CE Dt. 01.03.2016 after superseding Notification 14/2011 CE for excise and vide Notification 11/2016 Cus Dt. 01.03.2016, after superseding Notification 25/2011 Cus for CVD.

Now it is legally permissible to split the value of "goods" and "service" in case of any software and pay Excise duty (wherever applicable) and Service Tax on such respective values.

To clarify further,

Packaged Software

- If manufactured in India pay Excise duty on the basis of RSP, if RSP is required to be affixed under LM Act / Rules.
- If imported into India pay CVD on the basis of RSP, if RSP is required to be affixed under LM Act /Rules.
- If the said packaged software is "sold" absolutely, there is no service tax liability but appropriate VAT / CST needs to be paid.
- If the said packaged software on which ED/CVD is paid on the basis of Section 4 A, is not sold, but only licenced, no service tax is payable as per Notification 11/2016 ST DT. 01.03.2016.
- If there is no requirement to affix RSP as per LM Act / Rules, Excise duty / CVD is payable on the basis of transaction value.
- In such cases, if such software is not sold but only licenced Service Tax will apply and the value can be apportioned between the "goods" part of it and "service" part of it. The value on which service tax is paid can be excluded for the purpose of levy of Excise duty / CVD, as per Notification 11/2016 CE Dt 01.03.2016.

Customised Software

- If manufactured in India Excise duty is exempted vide S.No. 266 of Notification 12/2012 CE.
- If imported into India no CVD is payable in view of the above exemption.
- If the said software is "sold" absolutely, there is no service tax liability but appropriate VAT / CST needs to be paid.

- If such software is not sold but only licenced Service Tax will apply and the value can be apportioned between the “goods” part of it and “service” part of it and service tax can be paid on the value attributed to service. Still there would be no levy of Excise duty / CVD as the same is exempted.