# Tax on "software"- a work in progress

## Introduction

An interesting outcome of the unprecedented growth in the IT sector has been the evolving law in the assessment of software as "goods" or "services" for the computation of tax leviable on it. In the past, the notion was that only "tangible" movable property amounted to "goods," the sale of which was subject to sales or value added tax (**"VAT"**). However, judicial pronouncements have established that the term "goods" has a wide meaning and includes all types of movable properties, whether they are tangible or intangible. Accordingly, sale of "software" was also said to fall within the category of "sale of goods" so long as it was capable of abstraction, consumption and use.[1]

While software can be classified as "goods", there still remains some ambiguity surrounding the tax liability on its sale. This is particularly the case in contracts where there is a combination of sale of software by means of product development services. The question that often arises is whether a sale of "software" would come under the purview of VAT as a sale of goods, or under service tax as a provision of services, or both. This newsletter analyses the current position based upon the legal provisions and judicial interpretations.

### 1. Application of VAT to sale of software

**1.1** In India, VAT was introduced to replace sales tax in several states. Broadly speaking, VAT is tax that is payable by a "dealer"[2] who in the course of his business buys or sells goods directly or otherwise. He is liable to pay tax on every sale effected by him, from the day on which he is legally required to pay VAT, at state specific rates. The dealer charges VAT to the consumer and deposits it with the concerned authority. VAT is applicable on "goods" with "goods" being defined under the state specific VAT Acts. For instance, under the Delhi VAT Act, 2004, "goods" is termed as **(a)** every kind of moveable property (other than newspapers, actionable claims, stocks, shares and securities), **(b)** livestock, all materials, commodities, grass or things attached to or forming part of the earth which are agreed to be severed before sale or under a contract of sale and **(c)** property in goods involved in the execution of a works contract, lease or hire purchase or those to be used in the fitting out, improvement or repair of movable property.[3] This definition is similar to the definition included in the Sale of Goods Act, 1930 (**"Sale of Goods Act"**).

**1.2** The question of whether "software" qualifies as "goods" has been examined in numerous judgments. The position as it stands today was laid down in a judgment of the Supreme Court (**"SC"**) *Tata Consultancy Services v. State of Andhra Pradesh*,[4] wherein the SC examined whether software fell within the definition of "goods" under the Andhra Pradesh

[1] *Tata Consultancy Services v. State of Andhra Pradesh*, AIR 2005 SC 371
[2] Defined under the various state specific VAT Acts.
[3] Section 2 (m) of Delhi VAT Act, 2004
[4] AIR 2005 SC 371

Sales Tax Act, 1957. The SC in this case held that the word "goods" could not be given a narrow meaning and it included all types of moveable property whether tangible or intangible. It further observed that a "software programme" may consist of various commands which enable the computer to perform a designated task. While the copyright of that programme may remain with its originator, the moment copies are made and marketed; it becomes "goods" which are subject to tax. The SC compared computer software on CDs/floppies to music CDs or video cassettes. In both cases the software or music was put on the CD or other media for the purpose of transfer. At the end of the day the buyer was not paying for the CD or other media alone, but for the software or music on such media. Therefore, it was held that a sale of computer software was clearly a sale of "goods".

In this case, the test laid down by SC was whether the item concerned is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed, bought and sold. It was held that software *(canned or uncanned)* has all of these qualities and therefore constitutes "goods". In a concurring judgment, it was re-emphasized that "software" may be intellectual property but such property contained in a medium is bought and sold in various forms i.e., as a marketable commodity. What is essential for an article to be classified as "goods" is its marketability. This position was confirmed in several cases where it was emphasized that "property" *(tangible or intangible)* become "goods" if they have attributes with respect to (a) utility, (b) capability of being bought and sold, and (c) capability of being transmitted, delivered, stored and possessed.[5]

Thus, software being a marketable commodity, is considered "goods" subject to VAT.

## 2. Application of Service Tax

Subsequently, the Finance Act of 2008 introduced a new taxable service category of "Information Technology software".[6] The definition of IT software included services relating to development of software, adaptation, upgradation, enhancement, implementation of software, provision of advice and assistance on matters related to IT software, acquiring the "right to use" **(a)** IT software for commercial exploitation including the right to reproduce, distribute and sell, **(b)** software components for the creation of an inclusion in other IT software products, and **(c)** IT software supplied electronically.

Therefore, since May 2008, services falling within the aforementioned category, provided or to be provided to any person were subjected to service tax.

## 3. The confusion

The confusion arises where a contract includes a sale of "goods" as well as provision of "services," for instance, in contracts of "product development services" where the contract provided for production and development of software as well as services in that regard. Owing

[5] *Bharat Sanchar Nigam Limited and Anr v UOI and Ors* (2006) 3 SCC 1, *Infosys Technologies v. CTO* (2008) TIOL 509, *Infotech Software Dealers Association v. UOI and Ors* (2010) 236 CTR (Mad) 58

[6] It means 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.

to the complexity and ambiguity surrounding this matter, there was a risk of double taxation where the goods would fall within the applicability of VAT and service tax.

## 4. Current position

In order to understand the current position it is important to consider some of the important judgments and interpretations provided to legal provisions.

**4.1** In *Imagic Creative Private Limited v. Commissioner of Commercial Taxes and Ors*,[7] SC dealt with a situation that had elements of the aforementioned confusion. It considered the question of whether charges collected towards services provided by an advertising agency for development of a prototype conceptual design *(creation of a concept)*, on which service tax had been paid were also liable to a levy of VAT under the Karnataka VAT Act, 2003. In this case, the advertising agency was engaged in creating original concepts, design of advertising material and brochure, annual reports, etc. In the invoice generated, the agency had separated charges towards concept, design and other charges. When the agency filed its returns, the assessing officer examined the position and held that the entire ambit of activity conducted by the advertising agency was that of a comprehensive contract. The assessing officer was of the opinion that by separating the charges in the invoice, the agency had made an indivisible contract into a divisible contract, and accordingly, taxed the entire sale value including the creation of concept with 4% sales tax.

At this point it is important to understand the implications of a contract being indivisible. The Constitution was amended by the 46th amendment whereby article 366 (29A) was amended to bring about a legal fiction of a "deemed sale" in certain circumstances. The effect of this amendment was considered by SC in several cases.[8] In *State of Madras v. Gannon Dunkerley & Co (Madras) Ltd.*,[9] SC explained the effect of the amendment, observing that in case of certain specific composite contracts, namely; works contracts and catering contracts, splitting of service and supply was permitted because such contracts included elements of both service and sale. The SC further emphasized that in light of the legal fiction created by the 46th amendment, the works contract that was entire and indivisible was altered into a contract divisible into a contract of sale of goods and a contract for supply of labour. Accordingly, it held that the value of goods involved in execution of the works contract on which tax was leviable must exclude the charges that relate to the contract for supply of labour and services.

In light of the above, in the aforementioned case of *Imagic Creative Private Limited*, SC observed that by virtue of the 46th amendment a legal fiction was created which enabled certain indivisible contracts to be deemed to be divisible into contracts of sale of goods and contracts of service. Accordingly, it held that sales tax could not be imposed on the value of the "entire contract".

[7] 2008 (1) SCALE 356
[8] *State of Madras v. Gannon Dunkerley & Co (Madras) Ltd* 9STC353(SC), *Bharat Sanchar Nigam Limited v. UOI* AIR 2006 SC 1383
[9] 9STC353(SC)

**4.2** It is important to understand that, unless the transaction represents two distinct and separate contracts and is discernible as such, the State does not have the power to separate the agreement to sell from the agreement to render service and impose tax on the sale. This was emphasized by SC in *Gannon Dunkerley's* case where it laid down the "dominant nature test" for composite contracts other than those mentioned under the article 366 (29A) of the Constitution, whereby the test to determine if a contract falls into one category or the other is to look at the "substance of the contract" and the intention of the parties.

**4.3** Therefore, the position as it stands today appears to be that levy of VAT or service tax in case of contracts for product development services is based upon whether a "composite contract" can be divided applying the dominant nature test. Based on the facts and circumstances of the case, if the contract being a works contract or a catering contract can be so divided, service tax and VAT being mutually exclusive, they should be applied based upon the parameters of service tax and sales tax respectively.

**4.4** More recently, in *Infotech Software Dealers Association v. UOI and Ors.*,[10] the Madras High Court examined the question of whether "software" when supplied to a customer under an "end-user license agreement" was to be treated as a sale or service. In this case it was contended that an end-user license agreement did not have any element of sale, since the end user was simply provided by standardized software and a key *(code)* to activate the software by registering the same with the manufacturer via the internet. The end user was simply given a "right to use" and not ownership of the software. To answer the question, the Madras High Court applied the dominant nature test and held that in this particular case the intention of the parties reflected that the developer did not wish to sell the "software" and therefore, the transaction was not a sale of software as such, but the contents of the data stored in the software which only amounted to a "service". It held that the question as to whether a transaction would amount to sale or service would depend upon the individual transaction.

## Conclusion

From the judicial trend, it is evident that the term "goods" for the purpose of sales tax cannot be given a narrow meaning. Whether or not an item falls in this category is based on the question of whether the concerned item is capable of abstraction, consumption, use and whether it can be transmitted, transferred, delivered, stored, possessed, etc. In case of software all of these are possible. Further, it has been held that "goods" may be tangible or intangible and an item qualifies as "goods" if it has attributes regarding the following; **(a)** its utility, **(b)** capable of being bought and sold, and **(c)** capable of being transmitted, stored and possessed. If a software, whether it is customized or not, satisfies these attributes it will be considered as "goods".

However, while software may constitute "goods" the transaction may not amount to a "sale" in all cases. The question as to whether a transaction would amount to a "sale of goods" or "service" depends upon the individual transaction. In India, certain composite contracts are deemed to be divisible into "contract of sale of goods" and "contract of service". Accordingly, VAT is levied on the "goods" portion of the contract and service tax on the "service" element.

[10] (2010) 236 CTR (Mad) 58

For instance, where a company develops a product and sells it to the end-user along with services such as installation, maintenance, etc, such a contract may be deemed to be divided into a contract of sale for the "goods" portion and a "contract for service" for the services element with the assessee company liable to charge VAT as well as service tax respectively and exclusively. The question of whether a contract may be deemed to be divisible in to two components is determined on a case-by-case basis applying the dominant nature test. As there is no clarity in law on this aspect and a lot depends upon the interpretation of the parties to the transaction, many IT companies have started procuring both VAT and service tax registrations, and in many cases imposing both ultimately burdening the buyer, to safeguard themselves.

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