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## Indirect Tax Alert

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Karnataka High Court on software – sale, customization, implementation and annual technical support services

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## Summary

The activity of 'software implementation' by petitioner for a bank is a "mere service" through skill and human effort, and there is no right to use goods liable to VAT. However, VAT is liable on customized banking software whose proprietary right vests with petitioner and what is granted is only license transferring right to use such copyrighted article.

Maintenance & upgrades regarded as 'goods' and 'deemed sale' effected in course of rendition of annual technical support service by petitioner is liable VAT as works contract.

## Background

- The petitioner is engaged in the business of development and sale of information technology related services like customization of software, implementation of software, annual technical and support services, trading/support services of third-party software besides providing services and other related technical consultancy and engineering services.
- The petitioner developed a specialized universal banking software solution branded as 'Finacle'. Pursuant to the client-banks' specifications, Finacle required implementation to ensure that the client banks' requirements were met.

## Arguments of petitioner

- The petitioner has proprietary rights over the standard software 'Finacle' and the customized software.
- The petitioner has paid VAT on the consideration for such right to use software, which is a deemed sale.
- The customer has option of utilizing the service of the petitioner or any other person in the field for implementation of the contract. In this process, there is no transfer of any goods and hence, it is purely a service contract.
- The contract of sale also includes annual technical support involving both service and upgradation or enhancement of the software. This contract is in the nature of a works contract and hence, VAT has been discharged.

## Arguments of respondent(s)

### For the State

- The contract in question is a contract for sale. Without the process of implementation, the said software is not ready to go-live therefore it cannot be a mere service. Any customization of packaged software prior to sale renders the software a good and the transfer of right to use that goods involves sale and chargeable to VAT.

### For Union of India

- Once the parliament has expressly declared the service in relation to information technology software as a declared service, the jurisdiction of the State to levy tax on such activities has been excluded.
- Implementation is included in the definition of the 'taxable service' and therefore the petitioner is not entitled to reliefs sought by way of refund of service tax paid.

# Questions of law framed by the Hon'ble High Court

- In the absence of transfer of a right to use a software under a contract, can it be said that the activity of implementation involves a deemed transfer of goods as contemplated under Article 366 (29A)(d) of the Constitution of India?
- After supply of packaged and customized software, if any service is required to integrate the software into the system to make the software functional or usable, does it amount to pre-sale activity which is chargeable to VAT or is it a post sale activity, which is in the nature of service simplicitor?

## Decision of the Hon'ble High Court

### Sale of software

- The High Court summarized the decision of the Constitution Bench of the Apex Court in the case of *Tata Consultancy Services v. State of A.P.* (2005) 1 SCC 308; 2004-TIOL-87-SC-CT-LB,
  - That intellectual property once it is put on to a media, whether it be in the form of books or canvas or computer discs or cassettes, and marketed would become "goods".
  - What the buyer purchases and pays for is not the disc or the CD, he is purchasing the intellectual property which is embedded in the media.
  - Transaction involving sale of computer software is clearly a sale of goods within the meaning of the terms as defined even under the VAT Act.
- Circular No.17/2006-07 dated 24.7.2006 deals with levy of tax on software under the KST Act, 1957 and KVAT Act, 2003 and states that the packaged, readymade, off the shelf software are pure goods liable only to VAT.
- It is clear from the clauses of the agreements entered into by the petitioner that it has retained copyright and several proprietary rights in software and what is transferred to

the Bank is a non-exclusive, perpetual, non-transferable, limited license to use the software.

- The copyrighted article alone is handed over to the customer as a transfer of right to use goods, the software is goods and liable to VAT alone. By virtue of Article 366 (29A)(d) the right to use that software is deemed sale and is subjected to VAT.
- However, where the customer decides to work on a hired contract basis rendering pure service with future contracts for upgradation and enhancement, the copyright in such software belongs to the customer. Since there is no transfer of property in goods in such a case; what is provided is only a pure service, there can be no VAT liability, only service tax will be liable to be paid.

### Implementation

- The implementation process is a pure service rendition and does not involve any transfer of property, therefore is liable to service tax only. It is in the nature of service simplicitor.
- It is not obligatory for the bank/customer to have the services rendered only by the petitioner as a part of contract of sale or a condition of sale. It is open to the customers to have the services rendered by any other competent agency.
- Whether any charges collected by the seller towards such modification or change, generally called as customization in software sector, is a post sale or pre-sale expenditure would depend on the agreement/contract between the seller and the buyer, and on the actual conduct of the parties concerned as indicated by the relevant documents and books of account. The fact whether any such customization is done at the seller's premises or the purchaser's premises would not be of any relevance to determine this aspect.

### Annual Technical Support (ATS)

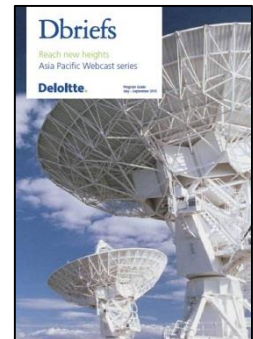
- In the case of ATS contract which includes annual maintenance involving both service and issuing upgraded or enhanced software, then such a contract is a combination of both goods and service i.e. is in the nature of a works contract. VAT is liable to be paid on the goods part and service tax is to be paid on the labour aspect.

# Upcoming Dbriefs - Register

## How do the New GST Rules Compare: India, Malaysia, and the OECD International VAT Guidelines? Chalk and Cheese?

**Tuesday, 22 September 2015, 02:30 PM – 03:30 PM IST**

In Asia Pacific, there are many new indirect tax systems being introduced. The Malaysian GST went live on 1 April 2015, and India moves forward with a dual GST that may be in force as early as 2016. What are the latest developments in the two countries? Stay current and find out how this may affect the way your business handles cross-border transactions and in-country transactions in both goods and services. For more information, visit the [Dbriefs](#) page.



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