Is supply of software a sale or a service?

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In a very recent and interesting judgement, the Madras High Court has come to some fundamental conclusions, in relation to taxability of supply of software to customers under a typical software licencing agreement (Infotech Software Dealers Association Vs. UOI).

The petitioners were dealers in software and approached the High Court through writ petitions impugning the extension of the service tax law, as contained in the Finance Act 1994, to software, on the grounds of being null and void, ultra vires and against the Indian Constitution. Specifically, the challenge related to the taxable service of provision of information technology software. It was the case of the petitioners that it was settled law, as per the judgement of the Supreme Court in TCS vs. State of Andhra Pradesh (2005) 1 SCC 308, that software was goods and hence transactions relating thereto could only be construed as sale of goods. Consequently, the States alone had the legislative competence to tax such transactions and hence the imposition of service tax in relation to such transactions by the Centre must be held to be without basis in law. It was also argued that while considering the transactions, the dominant intention of the parties would also be relevant, in terms of the Supreme Court's decision in the BSNL case, and in this regard as well it must be held that there could never be an intention for the contracting parties in relation to a software supply to provide a service to the other. It was also argued that the sale of software was, in any event, subject to VAT and hence the subsequent extension of the service tax in relation thereto was incorrect in law.

The particular transaction in question was in relation to software supplied in terms of a typical licence agreement, whereby the end user was given a limited right to use the said software. Of course, there were other transactions in relation to the software as well but it was the licencing agreement that was the subject matter of the detailed findings of the Court.

To begin with, the Court took note of the decision in the TCS case (supra) and concluded that software was undoubtedly goods, as it was an article of value having regard to its utility, capability of being bought and sold, and capability of transmission, delivery, storage and possession. Since software satisfied these conditions, it would indeed be goods, whether customized or non customized & whether tangible or intangible. The Madras High Court hence came to the obvious conclusion as above, by not only following the TCS judgement (supra) but also following its own earlier decision in the case of Infosys Technologies Vs. CTO (2008) TIOL 509 as well as the decision of the Karnataka High Court in Antrix Corporation Ltd. Vs. Assistant Commissioner of Commercial Taxes (2010) TIOL 515. Having taken note of the settled position as above, the Court then went into the nature of the underlying transactions. The Court came to the initial conclusion that notwithstanding that software was goods, the transactions whereby it was supplied to the customers would need to be considered for the purpose of taxation. The Court visualized cases of exclusives sales of software, exclusive services relating to software and cases where both the elements of sales and services were involved.

The Court thereafter considered the typical software license agreements, both the master agreements between the software owner and dealers/distributors as well as the end use agreements between the software owner & the individual end users. The Court took note of certain specific clauses thereof which stated as follows:-

- the agreement was between the software IP owner (Licensor) and the end user (Licencee)
- the IP owner retained the IP in the software & contained to remain the owner of the software in that regard
- the licencee could not sell, license or distribute copies of the

software.

- the licencee did not acquire any right to transfer or license or distribute the software and only obtained a limited right to use the software in question.

The Court arrived at a conclusion that the software owner retained the copyright in the software, regardless of whether it was canned, packaged or customized and that the transfer that took place was of a limited right to use, with copyright protection retained by the owner. The members of the petitioner association entered into master end use license agreements which enabled them to market the software to individual end users, under the end use licensing agreements in question. On a consideration of these factors, the Court held that in a situation as above, no transfer of the software took place at all and hence the provisions of the Constitution, under Article 366(29A)(d) thereof, in terms of deemed sales of goods were also not attracted to the case in hand. The Court therefore came to the conclusion that it could not be held that merely because software was goods, all transactions relating thereto must be outside the purview of the service tax, as they necessarily could only amount to actual sales of such software or deemed sales of such software, in the form of a transfer of the right to use such software. The Court held that such a conclusion could not be drawn and it was entirely possible to visualize situations where the transactions in relation to software, which was admittedly goods, were not covered within the ambit of either actual sales or deemed sales. Specifically, the typical software end user licence agreement in question visualized the contracting parties to enter into a services contract, whereby one contracting party would provide a service to the other, in relation to software. The Court therefore held that while it undoubtedly concurred with the Supreme Court in regard to the dominant intent test to consider taxability, that test was necessarily a factual one, to be conducted qua the actual transactions that were under consideration. There could not be any automatic or axiomatic conclusion that since software was goods, the dominant intent of the contracting parties, in relation to such software, could only relate to sales and not to services.

The Court therefore concluded that the provisions in the service tax law introducing the taxable service of information technology services were constitutionally valid and it could not be held that the Centre had no Constitutional powers to tax transactions relating to software. The Court said that it was always open for the petitioners to argue their case regarding the dominant intention of the parties and they could hence resist the imposition of service tax by demonstrating that the transaction was a sale and not a service.

It will be interesting to see how the impending GST addresses this tricky question. The central challenge of whether a transaction is a supply of goods or a supply of services would continue to be relevant since it is likely that the GST rates could be different across goods and services, at least for the initial years of the GST. As is known, the present understanding is that goods will be charged to a standard GST rate of 20 per cent or a concessional GST rate of 12 per cent, as the case may be, and there would be a convergence to a 16 per cent rate, over a three year timeframe. On services, the understanding is that the rate would be at 16 per cent from inception. If this were to come about, the challenge of determining the appropriate rate of GST on transactions relating to software supplies will continue to plague the industry for this initial period. It is therefore critical that the GST incorporates special rules in relation to taxation of software supplies and that they are uniformly and consistently applied.

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