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TAXATION OF SOFTWARE - A JOURNEY FROM DUSK TO DAWN

"Puzzle pieces don't always connect, do they?" - Ellen Hopkins

Information Technology ('IT') industry contributed 8 percent to India's Gross Domestic Product ('GDP') in 2020. IT has changed our lives completely in the past 50 years from wired to wireless, brick and mortar to digital, physical to virtual. It has replaced the manner of communication and is involved in every walk of life from medicine to outer space, agriculture to artificial intelligence; almost everything has become smart.

IT industry involves massive infrastructure in the form of world wide web, a network of cables, transmission and receiving equipment, satellites, operating equipment like computers *et al.* The backbone of IT however remains the software, a set of machine-readable commands which operate the equipment using the infrastructure to perform a desired function. Interestingly, Indian software industry has a potential to reach US\$ 100 Billion by year 2025.

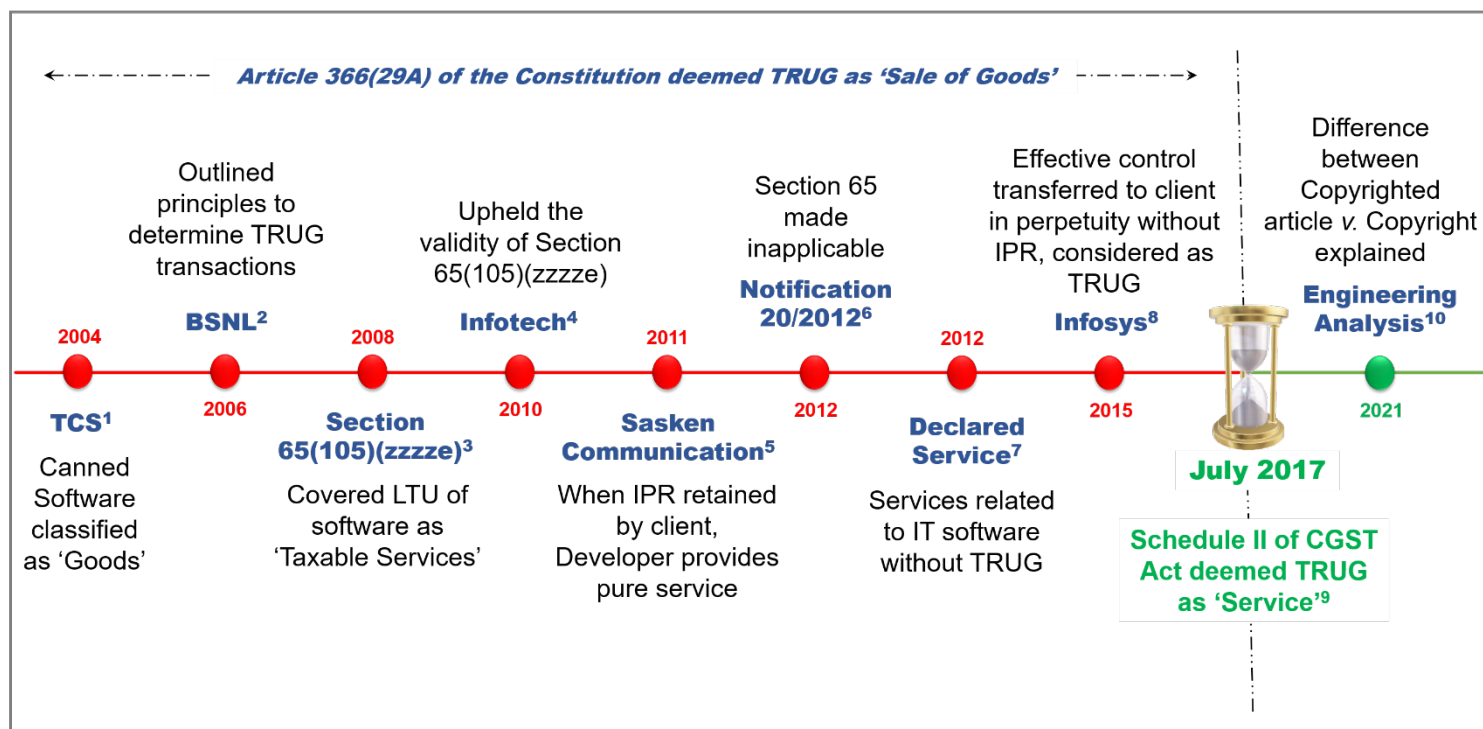
Taxation of software has throughout been a vexed issue in India. With a paradigm shift to GST regime, '**Taxation of software**' has witnessed a '*journey from dusk to dawn*'. Previously, a constant attempt was made by tax authorities to treat software as goods as well as service for levying both sales tax and service tax (*despite being mutually exclusive*) on the same aspect of transaction under varied scenarios. This resulted in cascading effect and posed a major challenge for taxpayers who mostly adopted conservative position by charging both taxes.

The dispute regarding classification of software was settled in the landmark judgement of TCS¹, wherein the Supreme Court classified canned software as 'goods', being capable of extraction, consumption, and use, which can be transmitted, transferred, delivered, stored etc. Medium of transmission had no influence on the classification of software. A catena of decisions dealt with various aspects relating to taxation of software without resulting in much respite for the taxpayers.

The epicenter of conflict shifted from classification to categorization of software. Clause (d) of Article 366(29A) of the Constitution of India, 1950 deemed '**Transfer of right to use goods ('TRUG')**' as sale. On the other hand, '**License to use ('LTU')**' goods were considered as a service under the Finance Act, 1994 leviable to service tax. All sales tax / VAT laws of states incorporated TRUG as deemed sale leviable to sales tax / VAT.

Ownership of any property is bundled with a set of rights, like right to possess, right to use / enjoy, right to consume, to destroy, or transfer, etc. While being the owner of a property, a person may transfer certain rights without transferring the ownership. In a transaction involving transfer of title in property, all the rights of owner are transferred to purchaser. On the other hand, in a transaction involving TRUG, delivery of possession of underlying goods by the transferor to the transferee is *sine qua non*, which is not the same as mere custody of goods.

‘Journey of Software from dusk to dawn’:



Terms being essence of an agreement, play a predominant role in determining tax implications. Complex software agreements are more prone to litigation owing to underlying transactions in intangible goods and incorporeal subject matter. Agreements should have explicit clause to specify whether the transaction pertains to transfer of Copyright *per se* or transfer of Copyrighted Article.

‘Copyright’ and **‘Copyrighted Article’** are distinct subject matters. Ownership of Copyright is different from ownership of Copyrighted Article in which copyrighted work is embodied. Further, the right to commercially exploit (reproduce, replicate, etc.) and mere right to use computer software are distinct rights. When the former is transferred, it amounts to parting of copyright i.e. Intellectual Property Right (‘IPR’). However, there is no transfer of copyright in the latter case. This distinction has been affirmed by Supreme Court in Engineering Analysis¹⁰.

The concept of **‘TRUG’** and **‘LTU’** can be understood using an example. If one buys a Microsoft Office license, the person acquires a right to use and enjoy the licensed software. However, no rights vest with the buyer to replicate or commercially exploit the software or to further sub-license the software to any other person as all such rights vest with the owner (Microsoft). Microsoft retains the right to reproduce and sell more licenses, make changes in the software and/or transfer the IPR in the software itself. Therefore, the buyer acquires TRUG (software) which is nothing but a Copyrighted Article, whereas the Copyright remains with Microsoft. On the other hand, if the buyer purchases a software license which restricts the use by buyer, and control over the software remains with the owner, then in such a transaction, the buyer merely acquires LTU of software for want of effective control.

Basis the principles laid down in various landmark judicial pronouncements under the erstwhile regime, various transactions in software have been plotted in the table below together with their tax positions in the erstwhile regime as also under GST for better understanding:

Scenario	Nature of Transaction	Implications under Erstwhile Regime	Implications under GST Regime
A. Effective Control			
With recipient (right to use software without right of commercial exploitation - Copyrighted Article)	TRUG	Sale of goods - Article 366(29A) of the Constitution	Supply of service - Entry 5(f) of Schedule II
With supplier (recipient has mere access to use the software with limitations)	LTU	Provision of service - Declared service as per Section 66E of Finance Act	Supply of service
Remarks - The above transactions involve transfer of bundle of rights and not all rights vested with the owner. If there would have been a transfer of all rights, then the transaction would have amounted to transfer in title, which is classifiable as supply of goods.			
B. Development / Upgradation / Customization of Software			
IPR vest with recipient	Pure service	Provision of service - Declared service as per Section 66E of Finance Act	Supply of service - Entry 5(d) of Schedule II
IPR vest with supplier	TRUG / LTU (depending upon effective control as discussed in (A))	If TRUG - Sale of goods If LTU - Provision of service	If TRUG - Supply of service - Entry 5(f) of Schedule II If LTU - Supply of service
Remarks - A transaction will tantamount to 'pure service' when the substance of contract provides that software which would come into existence post development, will be absolute property of the recipient since inception.			
C. Implementation / Installation Services of Software			
Mandatorily required to be provided along with main supply as under (A) and (B)	Ancillary to main supply	Classification as main supply	Classification as principal supply (being composite supply)
Recipient has an option to avail these services from 3 rd party vendors	Pure service	Provision of service - Declared service as per Section 66E of Finance Act	Supply of service - Entry 5(d) of Schedule II
Remarks - In scenarios where contract provides an option to recipient to avail implementation / installation services from 3rd party vendors, such supplies will qualify to be an independent supply of services.			
D. Transfer of IPR (Copyright)			
Temporary transfer of IPR	Pure service	Provision of service - Declared service as per Section 66E of Finance Act	Supply of service - Entry 5(c) of Schedule II
Permanent transfer of IPR [#]	Transfer in title	Sale of goods	Sale of goods - Entry 1(a) ¹¹ of Schedule II

#From the above table, disputes as regards categorization of software transactions between TRUG and LTU appear to have been settled under GST regime justifying its journey from dusk to dawn. Still the sun is hazy due to confusing multitude of entries in GST rate notifications.

On reading the relevant entries in the rate notifications, applicable GST rate is 18% for -

- 'Permanent transfer of IPR in respect of IT software' (*Goods rate notification*¹²)
- 'Temporary or permanent transfer or permitting use or enjoyment of IPR in respect of IT software' (*Services rate notification*¹³)

The above entries in Goods and Services rate notifications show a clear overlap of transactions relating to permanent transfer of IPR in respect of IT software. Surprisingly, Schedule II of CGST Act specifically covers 'permanent transfer of title' as 'goods' and nowhere treats the same as 'service'. *Qua* the software, title is transferred through transfer of IPR. Still the transaction of permanent transfer of title has been prescribed in Services rate notification. In Authors' considered view, this entry in Services rate notification is erroneous inasmuch as it is contrary to Schedule II deeming the transaction of permanent transfer of title as 'goods' as also the entry under Goods rate notification. It will be interesting to wait and watch how the revenue authorities and Courts would classify the transactions of permanent transfer of title (i.e. IPR) in respect of IT software.

Concluding remarks:

With the advent of GST, classification disputes in software transactions have been settled to a large extent. But there still exists an ambiguity regarding classification of transaction as 'LTU' in absence of any specific entry under Schedule II of CGST Act and no entry under Services rate notification except for online download of software. The conundrum further continues due to overlapping entries in Goods and Services rate notifications as regards permanent transfer of title (i.e. IPR) of IT software. It will be interesting to see how this unfolds in coming times and when software transactions will see clear sunny skies.

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1. *Tata Consultancy Services v. State of Andhra Pradesh* [2004-VIL-06-SC-CB]
2. *Bharat Sanchar Nigam Limited v. Union of India & Ors.* [2006-VIL-07-SC-LB]
3. *Section 65(105)(zzzze) of Finance Act, 1994 read as - to any person, by any other person in relation to information technology software including:*
 - i. *development of information technology software*
 - ii. -----
 - iii. *adaptation, upgradation, enhancement, implementation, and other similar services related to information technology software*
 - iv. -----
 - v. *providing the right to use information technology software for commercial exploitation including right to reproduce, distribute and sell information technology software and right to use software components for the creation of and inclusion in other information technology software products*
 - vi. -----
4. *Infotech Software Dealers Association v. Union of India* [2010-VIL-123-MAD-ST]
5. *Sasken Communication Technologies Limited v. Joint Commissioner of Commercial Taxes (Appeals)* [2011-VIL-67-KAR]

6. Notification Number 20/2012 - Service Tax dated June 5, 2012
7. Section 66E of the Finance Act 1994 specified 'Declared services'. Following are relevant entries:
 - c) temporary transfer or permitting the use or enjoyment of any intellectual property right
 - d) development, design, programming, customization, 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
8. Infosys Limited v. Deputy Commissioner of Commercial Taxes [2015-VIL-394-KAR]
9. Schedule II of CGST Act effective from July 1, 2017. Relevant entries of Entry 5 are reiterated below:
 - c) temporary transfer or permitting the use or enjoyment of any intellectual property right
 - d) development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software
 - f) transfer of the right to use any goods for any purpose whether or not for a specified period for cash, deferred payment or other valuable consideration
10. Engineering Analysis Center of Excellence Private Limited v. Commissioner of Income Tax & Anr. [2021-VIL-37-SC]
11. Entry 1 of Schedule II of CGST Act has been reiterated below:
 - a) any transfer of the title in goods is a supply of goods
 - b) any transfer of right in goods or of undivided share in goods without the transfer of title thereof, is a supply of services
12. Entry number 452P to Schedule III of Notification Number 1/2017 - Central Tax (Rate) dated June 28, 2017 states 'Permanent transfer of IP right in respect of Information Technology software'
13. Entry number 17(ii) of Notification Number 11/2017 - Central Tax (Rate) dated June 28, 2017 states 'Temporary or permanent transfer or permitting the use or enjoyment of IP right in respect of IT software'



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