

**Information Technology Services**

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The industry which has contributed for placing our country on the global map in the past decade has been slowly being bought into the mainstream of normal tax rules and restrictions albeit on a voluntary basis. It is expected that the domestic software service providers would face difficulty in complying with service tax provisions. This would be partly due to the nature of services being provided by this sector as well as the fact that “service tax” as a tax is still evolving even after 14 years of its introduction in the year 1994. The insertion of the new service category “Information Technology Software Service” as a taxable service with effect from 16.05.08 is however been an entry bought in at the behest of the industry as the government would end up with more than Rs. 6000 crores as refund payable for the year 2008-09 itself.

Prior to amendment made by Finance Act 2008, outsourced information technology services in relation to designing or developing of computer software or system networking or any other service primarily in relation to operation of computer systems had been escaping levy of service tax as there had been specific exclusion provided for the same under the category of business auxiliary service. This exemption had certain disadvantages in the sense that a service provider exporting IT services abroad in accordance with the Export of Service Rules 2005 could not go in for the benefit of refund of cenvat credits or for rebate under Rule 5 of the said Rules as the services exported were not regarded as taxable services because of the exclusion/exemption enjoyed by such services.

It is to be noted that there are various types of services being provided in the IT sector apart from software engineering services and that there is considerable confusion about the services that are taxable and the services that enjoy exemption. While software engineering might have been exempted earlier, the benefit of exemption did not extend to other services as well and these services would have to be distinguished from the core activities involved during software engineering. The services provided may include services like manpower supply, on-line information and database access or retrieval service, development and supply of content service, maintenance or repair of software, consultancy or advice in relation to software etc. Maintenance and repair of software sold off the shelf falls under management, maintenance and repair services category by virtue of the decision of the Supreme Court in *Tata Consultancy Services Vs State of Andhra Pradesh* ((2004) 11 LCX 008) wherein software sold off the shelf in

canned form was held to be goods and liable to sales tax as a consequence of which the term “goods” referred under management, maintenance and repair service category was clarified to include software. Consultancy or advise in relation to software that had been licensed was earlier regarded as part of software engineering and enjoyed the exclusion under consulting engineer’s service category by virtue of the decision given in SAP India Systems Applications & Products in Data Processing (P) Ltd Vs CST Bangalore ((2007) (02) LCX 356). Thus correctly classifying the services would assume significance. Further the software program or products were liable for VAT and the dividing line might be quite thin.

Finance Act 2008 has brought about certain amendments with regard to the taxability of information technology service. The changes not only include an insertion of a new category of taxable service, but also incorporate amendments in the existing categories of services to tax such IT services. Before we go to the new category of service, it would be worthwhile to go through the amendments made to some of the existing categories of services which are as follows –

- The exclusion for IT services under the category Business Auxiliary service has been removed and now information technology services provided on behalf of the client to ultimate customers would be liable to service tax.
- The definition of “technical testing and analysis” under Section 65(106) has been amended to include information technology software testing and analysis within its ambit. Thus services provided by technical testing and analysis agency in relation to technical testing and analysis of information technology software would henceforth be liable under the category “technical testing and analysis services”
- The definition of “technical inspection and certification” under Section 65(108) has been amended to include information technology software testing, inspection and certification within its ambit. Thus services provided by technical inspection and certification agency in relation to technical inspection and certification of information technology software would henceforth be liable under the category “technical inspection and certification services”
- Section 65(64) has been amended to include within the ambit of management, maintenance or repair of properties, management, maintenance or repair of information technology software. Thus in addition to maintenance or repair of packaged/canned software sold off the shelf, henceforth maintenance or repair or management of customized IT software too would be liable under this category.

- The definition of taxable service under consulting engineer's service category has been amended to withdraw the benefit of exclusion of software engineering services from levy of service tax since the advice, consultancy and assistance in relation to IT software would henceforth be liable under the new category of Information Technology Software services. An explanation has also been inserted clarifying that where services are provided in relation to advice, consultancy or technical assistance in the disciplines of both computer hardware engineering as well as computer software engineering, the service would be classified under consulting engineer service category.

***Information Technology Software Service – newly introduced category with effect from 16.05.08***

***Definitions***

As per Section 65(105)(zzzze) of Chapter V of Finance Act, "taxable service" means any service provided or to be provided to any person, by any other person in relation to information technology software for use in the course, or furtherance, of business or commerce, including –

1. Development of information technology software,
2. Study, analysis, design and programming of information technology software,
3. Adaptation, upgradation, enhancement, implementation and other similar services related to information technology software,
4. Providing advice, consultancy and assistance on matters related to information technology software, including conducting feasibility studies on implementation of a system, specifications for a database design, guidance and assistance during the startup phase of a new system, specifications to secure a database, advice on proprietary information technology software,
5. *Acquiring the right to use information technology software for commercial exploitation including the 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,*
6. *Acquiring the right to use information technology software supplied electronically.*

As per Section 65(53a), "information technology software" 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.

***What are the services liable?***

A review of the definition of taxable service under the new category of Information Technology Software service which has come into effect from 16.05.08 reveals that the said category seeks to levy service tax on customized software developmental activity. This has also been clarified by the department through its letter F.No. 334/1/2008 TRU dated 29.02.08. Moreover, IT software services must be provided for use in business or commerce and where they are for personal use, such services for personal use would not be liable to service tax. Most of the activities which form part of the Systems Development Lifecycle and required to develop and implement software from the conceptualization stage and up to the stage of final implementation would be covered under this category.

As highlighted above even the process of acquiring the right to use information technology software for commercial exploitation including the right to reproduce or to distribute or to sell the same has been covered by the definition under this category. Even acquisition of the right to use software components for the creation of and inclusion in other IT software products has been included. This could lead to considerable litigation in future if one were to also take into consideration the verdict given by the Supreme Court in Tata Consultancy Services case mentioned earlier where both canned and uncanned software were held to be capable of being regarded as goods. This was also reinforced by the decision of the Madras High Court in Infosys Technologies Ltd Vs CTO ( 2008-TIOL-509-HC-MAD-CT) where both tangible and intangible property (including customized or non-customized software) were held to be capable of being goods if they had the required attributes to hold them as goods. If that were the case, then acquisition of the right to use software or software components whether it is canned software or uncanned software could also be held liable under the sales tax law by the concerned authorities. Here where sales tax is leviable, the assessee would have to contend that the right is with regard to goods and that the acquisition of right with regard to the same cannot be subjected to service tax.

***Issues******Whether the acquisition of right to use canned software would be liable?***

In the opinion of the paper writers, what could be taxed here is the acquisition of right in respect of customized software as the transfer of right to use canned/standardized software would amount to transfer of right to use goods and liable under the sales tax law. This might have been inserted to tax distribution of ERP packages where there is some customization involved.

One should remember that canned/standardised software sold off the shelf is treated as “goods” as discussed earlier and subject to sales tax. Such canned software would also be subject to duty of excise where a manufacturing process is involved and finds mention under Chapter 85 of Central Excise Tariff Act 1985.

*Whether the service provider who exports IT software services abroad would be eligible to opt for refund?*

One advantage of the introduction of service tax levy on IT software services has been the opening up of options available for an exporter of services. The service provider exporting IT software services in accordance with the Export of Service Rules 2005 can have the option of going in for refund of the cenvat credit under Rule 5 of Cenvat Credit Rules 2004. Another alternative could be to go in for rebate of service tax paid under Rule 5 of Export of Service Rules 2005. (Note – the service has been put under the third category i.e recipient based criterion for the purpose of determining whether the service has really been exported out of India in accordance with the Export of Service Rules 2005 where the services are provided from India to a person residing abroad.)

*Whether IT software services received by an entity in India from abroad would be liable to tax?*

Yes. The service receiver in India would be liable to pay tax on such services received in India from abroad. Even here the taxability would be on recipient basis. Therefore assessee receiving such services would have to be careful and ensure that they do not ignore the possible liability in this regard. But where the services received constitute input services to the assessee, he can claim Cenvat credit of the service tax paid on such services received from abroad.

*Whether VAT can be levied on the value charged towards software engineering?*

Yes. The VAT authorities can tax software engineering activity especially where the software development is undertaken by the service provider and then the entire software which has been developed is sold as such to the customer. In this case the department can rightly contend that the same amounts to sale of goods.

But where the software development is undertaken at the request of the customer and the transfer of right over the software happens in stages on completion of the various stages or processes of the Systems Development Lifecycle, the developmental activity can also be regarded to be one of service or if property in goods is transferred a works contract which could

be held taxable under both service tax as well as VAT. Here it would be pertinent to note the decision given by the Supreme Court in *Imagic Creative (P) Ltd Vs CCT ((2008) 12 STT 392)* where service tax and VAT were held to be mutually exclusive and a composite contract involving sale of goods and provision of services was distinguished from an indivisible contract. Under the VAT law, one would be entitled to claim deduction for the labour charges included in the gross amount billed. In case of works contracts one could examine opting for notification 12/2003 ST which would require quantification for value of goods or materials sold during course of providing of service. Where this is possible, deduction can be claimed for the value of such goods or materials sold, and service tax charged on the balance. Where not quantifiable, one would not have any other option but to prove that the contract is one for sale of software and that the same is indivisible and subject to levy of VAT and not service tax though this may be questioned by the service tax authorities. Whatever the stand the industry takes it maybe advisable to disclose its stand to both the State and Central tax departments.

*Whether advisory services in relation to IT software would be classifiable under this new category?*

If one were to go by the definition of taxable service as well as the departmental letter F.No. 334/1/2008 TRU dated 29.02.08, services in the nature of advise, consultancy and assistance in relation to IT software would be covered under IT software service category.

The above of but the tip of the iceberg with many new issues expected. However the software industry would have much to cheer as they can now encash the excise duty if any paid on capital goods, inputs and the service tax paid on local services received or payments for import of services. The amount of refund is estimated to be anywhere between 1.5% to 4 % of the exports. This also means that professional advisors would have to meet the challenge of making the refund claims promptly and follow up to ensure maximization of the refund due to their clients. The internal and statutory auditors would also have to see that the products and services are properly categorized to avoid exposure to the industry.