Need for preventive Indirect tax Audits for IT/ITES sector

'Software' has been the soft target of multiplicity of indirect taxes including Excise duty, VAT, Service tax and Customs. Almost all major indirect taxes apply to this industry and this has created more confusion, more litigation and ultimately more revenue in the government coffers. Collecting of taxes by government is no harm, it is indeed the constitutional right of the government to levy and collect taxes. However, the recourse adopted by central and state governments by collecting the multiple taxes on the same transactions illegitimately, without the constitutional authority is a matter of great concern in the software industry. Since it is an indirect tax, and as the burden of tax is borne by the ultimate consumer, the software companies have in turn adopted a practice of collecting multiple taxes illegitimately from its customers to safeguard itself from the litigations. The complex transactions and the draconian tax laws have encouraged the entire industry in resorting to unconstitutional collection of taxes.

Apart from the issue of double taxation, there are many other taxation issues that has hindered in the growth of this industry. This article tries to explain certain issues faced by the software industry in respect of service tax and the need for indirect tax audits to tackle the same. An effective indirect tax audit streamlines the tax position and also gives the competitive advantage to the entity over its peers in terms of better pricing, compliance and value addition.

In service tax, with invasion of negative list regime, many activities such as development, design, implementation, customization, programming, adaption, upgradation or enhancement of information technology software has been brought under the service tax net as 'declared services', but still there are certain activities performed by software industry remains multiple issues grappling around this industry as under:

Issues in respect of Taxability of various softwares:

a) Issues in taxability of Canned softwares:

'Canned software' means a software that is designed and created for sale to more than one person and it is designed in such a way that large number of people can use it on a variety of hardware and it is also called as "Packaged Software" or "Standard Software" or "Branded Software". Softwares such as Lotus, Tally, Oracle etc. are the examples of 'Canned softwares'.

Determining whether the software is a goods or a service has been a part of very controversial subject for a long time. However, the issue got settled in the landmark judgment of *Tata Consultancy Services (TCS)*

vs. State of Andhra Pradesh wherein it was held that 'canned software' in the packaged form amount to 'Goods' and the same shall be liable to sales tax.

However, the judgment states that the canned software shall be exigible to sales tax ***only if it is sold in a packaged form***, i.e. off the shelf in a media such as CD, drive etc. However, what shall be the tax treatment in case the canned software is sold through an internet download (without any physical media) or if the canned software is updated online by way of patches. In both the cases there is no transfer of property in goods and ideally it shall not be liable to sales tax. However, based on the TCS judgment, the general perception has developed in the industry that the canned software irrespective of its mode of transfer is always liable to sales tax. This unclear understanding of the tax treatment has led to many software companies collecting both service tax as well as VAT on the same tax base either out of ignorance or in order to avoid departmental harassment which inadvertently has led to increase in the cost of software and also promotes collection of taxes without any constitutional authority.

Issues in the taxability of Customised software:

'Customised Software' means the software created for a single person or a specific customer to meet his specific requirement and it is also called as "Tailor-made Software" or "Specific Software".

Customisation of software is declared to be a service and the same is liable for service tax. However, there can be a case wherein the customized software so developed is delivered to the client on media like a CD. In such a situation, whether the transaction will be liable for service tax as declared services or will it be liable for sales tax based on the TCS Judgement?

As per the education guide issued by CBEC, it is clarified that customized software amounts to declared service even if it is delivered on a media like CD, drive etc. and shall be liable for service tax. However, Apex Court in the case of *Tata Consultancy Services (TCS) vs. State of Andhra Pradesh*, has held as under:

> *"Indian law does not make any distinction between tangible property and intangible property. A 'goods' may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold; and (c) capable of transmitted, transferred, delivered, stored and possessed. If a software* ***whether customized or non-customized satisfies these attributes, the same would be goods****".*

It is seen in the above judgment that, even in customization of the software, if certain attributes are fulfilled, then it can be termed as goods and can be leviable to sales tax. However, no conclusive opinion was formed by the apex court in the above judgment as to whether or not the unbranded software shall be levied to sales tax. Apex court further noted as under:

> *"Thus even unbranded software, when it is marketed/ sold, may be goods. We, however, are not dealing with this aspect* ***and express no opinion thereon because in case of unbranded software other questions like situs of contract of sale and/or whether the contract is a service contract may arise****".*

Therefore, from the above judgment, it can be said that mere customization of a software does not lead to a conclusion of its leviability to service tax. If the customization of the software satisfies the above attributes, then it can be liable for sales tax and the sales tax demands could come up roaring based on the above judgment. Therefore, one has to decide the taxability of customized softwares properly based on the terms of the contract and the dominant nature test.

Issues in the taxability of the Rights to use software (license):

Regardless of being a "goods" or "service," there is a third category wherein, the original manufacturer, who creates the software, only licenses the software for the private use of the end user subject to the terms and conditions. At no stage an end user becomes the absolute owner of the software. The end user simply agrees to the terms and conditions, runs the software and gets it installed onto its operating system and also gets updates of the same.

In this case, software is basically an Intellectual Property as it is protected under the Copyright Act, 1957. The license to use the software is usually coupled with conditional acceptance of software licence agreement which gives the buyer the 'right to use' the software subject to certain terms and conditions stated in the agreement. Thus, on purchasing the software, the buyer becomes the 'licensee' and 'not the owner of the software' itself. A buyer can use, abstract, consume, deliver, store, possess, transfer and transmit such property only in consonance with the license agreement but he cannot resell or exploit it commercially for his own gain or profit. Therefore, if a pre-packaged or canned software is not sold but if it is transferred under a license merely to use such software, then the transaction cannot be directly termed as a 'sale' or 'service' but will be covered either under the ambit of 'deemed sale' or 'declared service'.

In case, the rights to use the software are also transferred along with the licensing of the software, then the transaction will be covered under the purview of 'deemed sale' under sub-clause (d) of article 366(29A)

and would attract sales tax. However, if the rights to use the software is not transferred in the course of licensing of the software, then the transaction falls within the clutches of 'declared service' under Clause (f) of Section 66E of the finance act, 1994 and would be leviable to service tax.

Therefore, one has to read the terms and conditions of the licensing agreement carefully to understand whether or not the rights to use has been transferred. In case the terms of the license imposes any restrictions on the usage of such licenses, which interfere with the free enjoyment of the software, then such license may not result in transfer of right to use. However, conclusion cannot be drawn based on the interpretation of individual clauses in the agreement. One has to read the agreement in full and true intention as to the transfer of the rights to use has to be drawn.

Taxability issues in Cloud Computing:

'Cloud computing' are the softwares on demand, available anywhere, at anytime subject to availability of an internet connection and they are scalable as per the needs of the user. There are three major models of delivering 'clouding computing' services to businesses as follows:

A) Infrastructure as a Service (IaaS) Model - Under this model, IT infrastructure in the form of data centers, virtual servers, network infrastructure, equipment, etc are sourced as a service from third party service providers. The customer does not manage or control the underlying cloud infrastructure, but has control over the operating system, storage, and deployed applications, and may be given limited control of select networking components.

B) Platform as a Service (PaaS) Model - Provides a computing platform and programming tools as a service for software developers. The client does not control or manage the underlying cloud infrastructure, including the network, servers, operating systems, or storage, but has control over the deployed applications.

C) Software as a Service (SaaS) Model - Service provider hosts several software applications for consumers to use as and when required thereby eliminating the need to install and run the software application on the consumer's own infrastructure. It can be provided either to business customers (B2B) or to individual customers (B2C).

Sales Tax is levied on the sale of goods. However, sales tax is also levied as deemed sale in case of leasing of goods when the ultimate possession and control to use the underlying product *is also transferred to the user*. On the contrary, service tax is levied on the leasing of goods when the ultimate possession and control to use the product *is not transferred to the user*.

Generally, in cloud computing transactions, no Control and possession of the server is transferred, instead, only a place is provided on the server to use against a payment but the user is not authorized to control the server itself. However, if the agreements are not properly drafted disputes of VAT on these transactions cannot be ruled out. For instance, in some cases, the agreement states that the '*user has the right to dictate the type of hardwares to be used'* or *'the right to control over the space allotted*'.

It is seen that the VAT Authorities uses these type of clauses against the assesees and demand VAT on such transactions on the grounds that the the control over the equipments/ space is transferred on the user.

Since, the issues are new and transactions are tricky and therefore if the contractual evaluation is not taken care of timely, then even a transaction not genuinely liable to VAT could also be brought under clutches of VAT. Therefore, agreement needs to be carefully reviewed and the clauses loosely drafted and the litigative ones needs to be chalked out to avoid any unnecessary intrusion of the VAT on such transactions.

Supreme Court in case of Imagic Creative (P) Ltd. Vs CCT & Ors, 2008 has held that a transaction cannot be leviable to both Service tax and VAT. However, given the ambiguity in the law and litigation involved, software companies are charging both. However, if a software companies get its transactions reviewed by the indirect tax experts and pay only the right taxes, then it would give them the huge pricing advantage over its competitors.

Apart from above taxability related issues, there are many other specific issues looming around this sector as far as service tax is concerned as explained below:

Valuation issues:

The repairs and maintenance contracts entered into by the IT companies often involves transfer of software, hardwares and servicing charges. In such cases, if the material and the labour portion can be segregated then the service tax needs to be paid only on the service portion. However, many times it may not be possible to determine/segregate the material and labour portion. For instance, in case of AMC contracts, element of goods and services involved in the transaction cannot be pre-determined. It is seen that this helpless situation of the asseesse is used by the service tax authorities and state VAT authorities to maximize the tax collections.

If material and service portion cannot be segregated, then 70% of the value is deemed to be the standard service element as per the service tax law. Similarly, in the same situation 70% is being treated as the standard element of goods by almost many state VAT authorities leading to payment of indirect taxes on around 140% of the tax base which is illegal tax intrusion by the states and centre on the same tax base.

Issues in refund of CENVAT credit:

Due to intangible element of the information technology software and its easy transfer across geographical locations, this sector is an export hub. Although, government policies always promote exports by various tax incentives to the exporters. One noted tax incentive in case of export of services, is that input services used for the export services is eligible for refund. However, the boon offered by the tax authorities has turned out to be one of the biggest bane due to challenges being faced by the software companies in getting the refund. Few issues faced in claiming of refund of input services are as under:

a) Issues of denial of CENVAT credit on the grounds of input services not having nexus with the output services exported;
b) Defective documentation in the refund application - For instance, in certain cases, the lower authorities have taken a view that production of foreign inward remittance certificate by the claimant to claim refund is not sufficient. A certificate from the bank certifying that the amount in the invoice has been received specifically with reference to the invoice has to be made available, which at times become challenging;
c) Denial of refund based on deficient input service invoices;
d) Issues in calculation of the refund claim based on the formula prescribed;
e) Denial of refund claim on the grounds of delay in filing of refund application after the expiry of period of limitation of 1 year.

Issues in determination of place of provision of services:

In the case of cross border transactions, service can considered to be an export of service if the place of provision of service is outside India either based on rule 3 or if the service is performed outside India based on rule 4 of place of provision of service rules, 2012. However, since information technology software services have very close nexus to the 'Online information database access or retrieval services', it is seen that demand notices are being raised on the assesses treating the services provided by them as 'Online information and database access or retrieval services' and applying rule 9 of the place of provision of service rules, 2012. Once rule 9 is applied, place of provision of service is considered to be the location of service provider i.e. (Taxable territory) and thereby denying the benefit of export.

Further, services in respect of import of software is liable for service tax under reverse charge in the hands of the recipient of service. However, service tax under reverse charge does not apply if the transaction is covered under rule 9 of the place of provision of service rules. But if any other rule is applied including rule 3, then the said transaction comes under the ambit of service tax under reverse charge in the hands of the recipient of service. Therefore, understanding of the transaction and applying the correct rule plays a key role in determining the tax obligation.

Solution through a detailed Indirect Taxes audit:

Apart from above issues in service tax, there are also issues faced by software industries in VAT and central excise. Since prevention of the disaster is always better than its cure, therefore it is based on this theory that the software companies must get their indirect tax positions set right. As highlighted above, there are numerous indirect tax issues looming the software industry and therefore instead of paying huge taxes along with high interests and penalties at the order of department and to avoid long lasting departmental disputes. Software companies must get the indirect tax audits done. Such audits are not general in nature like any other statutory audits, but instead they are management based audits that target the specific area (indirect taxes) with utmost precision and reports the risks and non-compliances the company is exposed to in the indirect taxes. Also, since it is performed by the subject experts, therefore various value additive techniques to optimize the tax positions will also be brought to the notice of the management. Various aspects that can be covered by the indirect tax auditor and its benefits to the software industry could be as under:

a) Review of various terms of customer & vendor contracts and suggesting changes therein to avoid any tax disputes or to provide value addition;
b) Understanding the transaction in substance and paying the right tax instead of paying multiple taxes, thereby having a pricing advantage over competitors;
c) Suggests various CENVAT credit optimization techniques to ensure timeliness, completeness and correctness in availment of CENVAT credit;
d) Suggests reversal of ineligible CENVAT credit wrongly taken;
e) Checks the compliance to point of taxation rules thereby ensuring timely payment of taxes to avoid high interest costs;
f) Assists in determining the situs of taxes is in line with the place of provision of service rules;
g) Assists in accumulation of CENVAT credit for refund claim and checking the compliance of the procedural requirements to get the refund;
h) Updates the entity with latest changes in indirect taxes and ensures compliance;

In a nutshell, indirect tax auditor brings the overall view of the indirect tax compliance to the notice of the management. These type of one time health checks, rest assures the management of its indirect taxes exposure for a considerable period of time.

- **By CA Ravi Kumar Somani**

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