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Updates on
• Tax

TAX

A. Package Software exempted from double tax

A mass market software product, generally, available in packed form is known as package or canned software. It is the type of software, which caters to the needs of a variety of users and is capable of being used with variety of hardwares. The IT software being covered under Information Technology Agreement is fully exempt from basic customs duty. So far as excise duty/Counter Velling Duty ("CVD") (in case of imports) is concerned, packaged software attracts duty @ 8.24% (including cess) and customized software is fully exempt from payment of duty.

In addition to excise duty/CVD on package software, the transfer of right to use of the software for commercial exploitation (IPR component), is chargeable to service tax @ 10.3% under the head 'Information technology software service' ("ITSS"). Normally, cost of a software supplied in a media consists of two components, namely,-

- (a) the cost of the actual software, i.e. set of information which is placed on a media; and
- (b) the cost of the intellectual property right ("IPR") relating thereto.

While customized software is chargeable to service tax only, the packaged software attracts not only service tax but also excise/CVD duty. To avoid double taxation, two parallel

notifications were issued on the excise¹ and customs² side. Partial exemption from excise duty was extended to packaged or canned software on that portion of value attributable to transfer of 'right to use', as on this portion, service tax would be leviable under the ITSS.

In spite of exemption notification, the custom department, in most of the cases, is not allowing the exemption to the importers of Shrink wrap software³ and fully packed product⁴ on the IPR component chargeable to service tax.

To the rescue of the importers, the Central Board of Excise and Customs ("CBEC"), laying emphasis on the above exemption notifications, has clarified⁵ that splitting of the value of the imported goods into that pertaining to software on media and the one pertaining to right to use is permitted under law and exemption is available to Shrink wrap software.

¹ Notification No. 22/2009-CE dated 07.07.2009

² Notification No. 80/2009-Cus dated 07.07.2009

³ Shrink wrap software consists of a box containing software on media, users manual and end-user licence agreements, which is shrink wrapped in plastic cover and is always sold as a set

⁴ Fully packed product having split value (separate invoice value for media and right to use of software).

⁵ Circular No. 354/189/2009-TRU

B. Service Tax

The issue whether telecommunication services are taxable as 'services' or as 'sale of goods' was settled by the larger bench of the Supreme Court of India ("SC") in the matter of Bharat Sanchar Nigam Limited Vs. Union Of India⁶ ("BSNL Case"). The SC held that telephone service was a service without any element of sales in it and the electromagnetic waves or radio frequencies used as a medium did not fall in the definition of "Goods" for the purpose of Article 366(12)/366(29A)(d) of the Constitution of India and State Sales Tax Legislations. However, in a recent judgment⁷, Karnataka High Court ("HC") took a different view and held that providing broad band services amounted to 'sale of light energy' and thus the entire consideration for that was taxable, under the Karnataka Value Added Tax Act, 2003 ("KVAT Act"), despite the same also being assessed to service tax.

Facts-

Bharti Airtel Ltd. ("Appellant") challenged the order dated March 16, 2007 passed by the HC wherein the HC had declined to interfere with and quash the order of re-assessment dated January 12, 2007 ("Order") passed by the Deputy Commissioner,

⁶ 2006 (3) SCC 1

⁷ Bharti Airtel Ltd Vs. State of Karnataka & others 2009 -TIOL-99-HC-KAR-VAT

Commercial Tax, ("Assessing Authority") and consequent 12 notices of demand issued by the Assessing Authority for the months of April 2005 to March 2006 demanding the tax from the Appellant ("Notices"). The HC declined to interfere with and quash the Order and Notices on the ground that the Appellant had not availed the statutory remedy provided under the KVAT Act. Therefore, the Appellant challenged the legality and correctness of the HC's Order vide writ appeal no. 629 of 2007.

The Appellant had established telecom infrastructure for providing 'broadband connectivity' by laying down about 35,000 kms optic fibre cables ("OFC") across India. These OFC have enormous data carrying capacity at very high speed at which the light travels without any interference. The Appellant provided service of telecom connectivity to its subscribers from one 'point of presence' to one or more "points of presence" through a complex network of copper cables/OFC. This service in commercial parlance is called as "leased lines" whereby the Appellant allotted to a particular subscriber a particular 'bandwidth'. A 'bandwidth' means the rate at which data is transferred across a transmission medium and is measured in units of 'Kilobits per second' /'Megabits per second'. Each subscriber was provided with different bandwidth(s) depending upon the individual needs. The

Appellant entered into a 'Service Level Agreement' ("SLA") with all its subscribers.

Once a particular bandwidth is allotted to a particular subscriber, the latter has the freedom to transmit any amount of data throughout the period of subscription from one end to another and for this the Appellant charges the subscriber a fixed sum for the subscription period. The Appellant argued that as it did not affect any sale of goods, it would not be required to pay any tax under KVAT Act. Therefore, it submitted monthly returns showing taxable turnover as "Nil".

The Assessing Authority issued the Notices under the KVAT Act rejecting the Forms VAT-100 submitted by the Appellant and concluding re-assessment, by adding to the turnover, the amounts received by the Appellant towards leasing of broadband by treating the same as 'transfer of right to use goods', on the ground that the Appellant had leased the physical lines of optic fiber to its various subscribers. The Assessing Authority passed the impugned Order and thereby confirmed the entire demand proposed in the Notices and imposed penalties and also levied interest on the tax said to be payable and due by the Appellant.

Though the Appellant had alternative remedy by way of appeal under the provisions of KVAT Act, however, it took the stand that the same could not be efficacious one, in as much as, for availing the said remedy of appeal, the Appellant was to make deposit of more than Rs. 12 Cores. Furthermore, the impugned Order was passed by the Assessing Authority in gross violation of the fundamental rights of the Appellant under Articles 14 and 19(g) of Constitution of India.

The points raised for determination under the appeal were as follows:

- (1) Whether the HC was justified in dismissing the writ petition⁸ and in declining to quash the Order and Notices on the ground that the Appellant had not availed the statutory remedy of appeal provided under KVAT Act?
- (2) Whether the Assessing Authority under VAT was justified in passing the impugned Order on the ground that the broadband connectivity provided by the Appellant to its subscribers amounted to "sale of light energy" taxable under section 3 of the KVAT Act?
- (3) Whether the Government of Karnataka has authority under the Constitution of India to levy tax on the Appellant under

the provisions of KVAT Act in respect of its transaction of providing broadband connectivity to its subscribers, for the reason that 'Service Tax' had already been levied on it by the Union Government under the provisions of 'Finance Act 1994' treating the said transaction as 'Service'?

Judgment-

- (1) On the first point, the HC agreed with the Appellant that the question whether the transactions of the Appellant with its subscribers could only be service or it involved the element of sale of goods making it liable to be taxed under the provisions of KVAT Act and whether the Appellant could be taxed under both the said provisions, could not be decided by the Appellate Authority under the KVAT Act. Therefore, the HC held that the Appellant could maintain its writ petition and as such the HC was not justified in dismissing the original writ petition only on the ground that the Appellant had not availed an alternative statutory remedy available to it under the KVAT Act.
- (2) For Point 2 the HC observed that:
 - (a) The transmission of data of its subscribers was carried out by the Appellant by creating the artificial light energy and making it to travel through the OFC laid by

⁸ no. 1537/07

it. Therefore, the Assessing Authority had rightly observed in the Order, that "light energy" was artificially created by the Appellant within its network and was a must for such transmission of data from one point to another through Optic Cable network laid by the Appellant.

- (b) However, in order to impose sales tax/VAT it was further necessary to determine whether such artificially created light energy was capable of being held as "goods". For that HC relied upon the opinions of the experts in the field which were obtained by the Assessing Authority and the Appellant. From the perusal of opinions, it was clear that the 'electro magnetic waves' used in the operation of mobile phones and the 'artificially created light energy', though both were 'electro magnetic waves of high frequency', were nonetheless distinct as they had different characteristics and were used for different purposes. Further the artificially created light energy was capable of being possessed, transmitted, delivered and used, and, to some extent, stored. Therefore, despite application of the ratio in the BSNL Case on which strong reliance was placed by the Appellant to the facts of the present

case and relevant observations of the SC in all its earlier decisions discussed including those considered by SC in BSNL's Case, the HC held that the 'artificially created electrical light energy' which was used for transmission of data of the subscribers through the OFC network fell under the definition of "goods" as provided for in Article 366 (12) of the Constitution of India; Section 2(15) of the KVAT Act 2003 and also Section 2(7) of Sale of Goods Act 1930.

- (3) For point 3 High Court observed that:
- (a) Following the observations of SC, even if the activities of the Appellant were comprehensively termed as 'service' under the SLA, it was still covered in the description of 'sale' within the meaning of section 2(29)(d) of KVAT Act, and therefore they were to be regarded as 'sale of artificially created light energy' for the purpose of the said statute despite the said activities being held as 'service' for the purpose of Finance Act 1994.
- (b) The composite transaction between the Appellant and its subscribers in providing broad band connectivity to the subscribers, the two elements of service and sale

could not be split therefore the Assessing Authority in the Order rightly held that the entire proceeds received by the Appellant from its subscribers as 'service rentals' should be brought under the provisions of KVAT Act.

To sum up the HC while deciding the writ appeal held that:

- (i) the activity of providing broad band connectivity by the Appellant to its subscribers amounts to 'sale of light energy' taxable under Section 3 of the KVAT Act, and
- (ii) the Government of Karnataka is competent to levy tax on the said sale under the provisions of the KVAT Act on the entire proceeds collected by it from its subscribers as "lease rentals" despite the Appellant being assessed to service tax on the said activity by the Union Government under the provisions of Finance Act, 1994, treating it as 'service'.

Aggrieved by the above said order the Appellant appealed⁹ to the SC and the SC after looking into technical nature of the issue involved remanded the matter back to First Appellate Authority with a direction to decide the matter a fresh.

Analysis-

- The SC has though remanded the matter back to decide the matter a fresh after considering the technical evidences and cross examination of the experts, but at the same time, it has kept the issue opened. As, if reaffirmed, it will again create an ambiguity about the taxing of the services of complex nature which involves both service and transfer of goods in it.
- Also in a composite contract, where it is difficult to segregate the provision of services and sale of goods, the question remains if there can be an imposition of two taxes VAT/Service Tax on single transaction.

⁹ 2009-TIOL-36-SC-VAT

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