IN THE HIGH COURT OF KARNATAKA AT BENGALURU

DATED THIS THE 18TH DAY OF SEPTEMBER 2015

PRESENT

THE HON'BLE MR. JUSTICE N.KUMAR

AND

THE HON'BLE MR. JUSTICE B.MANOHAR

S.T.R.P.No.215/2011

BETWEEN :

The State of Karnataka
Rep. by the Secretary,
Finance Department,
Vidhana Soudha,
Bangalore - 560 001. ...PETITIONER

(By Prof. Ravivarma Kumar, Advocate General, along with Sri.K.M, Shivayogiswamy, Govt. Advocate.)

AND :

IBM India Private Limited
Formerly known as
M/s IBM India Ltd.,
Subramanya Arcade,
No.12, Bannerghatta Road,
Bangalore – 560029
Rep. by Vasu Ranganath
Tax Analyst, Finance – Taxation. ...RESPONDENT

(By Sri Madhavarao, Adv. for Smt.Vani H., Adv.)

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This STRP filed under Section 25(1) of KST Act, against the judgment dated 09.12.2010 passed in S.T.A.No.943/2009 on the file of the Karnataka Appellate Tribunal, Bangalore, allowing the appeal.

This Petition coming on for further hearing this day, N. Kumar, J made the following:

O R D E R

The revenue has preferred this Revision Petition against the order passed by the Karnataka Appellate Tribunal deleting the levy of tax under KST Act and holding the activities of business consultancy services and implementation of the Enterprises Re-source Planning software as pure services not involving any sale of goods or any transfer of property in goods in the execution of works contract.

2. The assessee is a registered dealer under the provisions of the Karnataka Sales Tax Act (hereinafter for short referred to as 'the Act'). The assessment order for the assessment year 2004-05 was concluded by the assessing authority by accepting the declared turnover. The re-assessment proceedings were initiated by the assessing

authority noticing that there was under-assessment in the order concluded on 23.11.2006 and, therefore, passed the re-assessment order on 27.2.2008. The assessee preferred a Writ Petition in W.P.No. 5028/2008 before this Court challenging the re-assessment order. By an order dated 27.3.2008 the Writ Petition was partly allowed by setting aside the re-assessment order and remitting the matter to the assessing authority for fresh disposal after providing a reasonable opportunity of being heard to the assessee. After such remand, the assessing authority concluded re-assessment proceedings by his order dated 25.8.2008 levying tax on activities of business consultancy services and the enterprises resource planning software. Challenging the said order, the assessee preferred an appeal before the first appellate authority who confirmed the order of the assessing authority by its order dated 5.3.2009. Challenging the said order, the assessee preferred a second appeal before the Karnataka Appellate Tribunal in STA No. 943/2009. The Tribunal has passed the impugned order on 9.12.2010

setting aside the order passed by the assessing authority as well as the first Appellate Authority and setting aside the levy of tax on the activities of business consultancy services and Enterprises Re-source Planning software holding that the said activities are pure services not involving any sale of goods or any transfer of property in goods in the execution of works contract. Aggrieved by the same, the revenue has preferred this revision petition.

3. The following questions have been framed for consideration in this Revision Petition : -

> *(1) Whether the Karnataka Appellate Tribunal is justified in giving a finding that ERP software implementation services and in business consultancy services activities carried on by the respondent does not involve any transfer of property in goods and cannot be considered as sale or deemed sale in the course of execution of works contract?*
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> *(2) Whether the Karnataka Appellate Tribunal is right in setting aside the orders passed by the Assessing Authority – the First Appellate*

Authority holding that the ERP software implementation and BCS services of the respondent does not fall within the ambit of "sale" as defined under the KST Act?

(3) Whether the services of software developed as per the requirements of the customers on the basic software is development of software or not?

4. The assessee is a registered dealer under the Act. It is engaged in the following activities : -

(a) Development and sale of software and net working products,
(b) Trading in Computer System;
(c) Undertaking of Information Technology related jobs/services.

5. The case of the assessee is that, in respect of the activity of the business consultancy services, the customers approach the assessee for such services. Then the assessee's team of business consultants examine the request of the customers and then conduct Business Process Review (hereinafter for short referred to as 'BPR') under Business Consultancy Services (hereinafter for short referred to as

'BCS') programme, and identify and recommend a suitable ERP (Enterprise Resource Planning) software to the customer. Then the necessary ERP software is purchased by the customer, on the result of the BPR performed by the assessee. The customer purchases the software from software vendor and then the software vendor executes licensing agreement with the purchaser of the software and sells the software to the assessee's customers. Thereafter ERP implementation team of the assessee enters into contracts with the customers for ERP implementation services if the customers seek such implementation. The ERP implementation service is independent of the earlier business consultancy service. Every customer does not contract for both the BCS and ERP implementation service together. When ERP software is purchased by the client such software needs to be installed, integrated and implemented at the client's end. The installation of ERP software is performed by the project implementation team comprising of the personnel of the assessee company, along

with the employees of the client. The members of the ERP software implementation team of the assessee play various roles in the ERP software implementation process depending on their skills. The team with the skill ensures that the ERP software is appropriately integrated in the system of the client, and thereafter implementation of the said software is done. In this implementation process the experts team of the assessee will take all necessary steps to provide functional data for the installation of the ERP software and it becomes useful for the client.

6. The case of the assessee is that, in the activities of BCS and ERP software (purchased by the customers from other vendors) implementation, the assessee provides only services and no transfer of property in goods is involved. Service tax on ERP implementation services (which is attracted with effect from 16.5.2008) has been paid on such services. BCS does not involve transfer of property in goods. Service tax is also paid on BCS receipts. In both only the

service is provided and these two services involve no transfer of property in goods.

7. Prof. Ravivarma Kumar, the learned Advocate General, relying on clause 2 of the agreement which deals with deliverable materials and clause 2.2, where it is categorically stated that IBM will transfer to the customer, IBM's rights in the deliverable materials subject to the conditions mentioned therein, and Clause 2.6 which provides that such rights transferred by IBM to the customer are subject to payment by the customer all amounts due under the agreement, submitted that a clear case of sale of software could be gathered from the agreement. Therefore, he submitted that the finding recorded by the Tribunal ignoring the specific provision in the agreement is erroneous and requires to be set aside. He further submitted that the agreement for providing service on which reliance is placed by the assessee includes code writing involvement. The said code writing constitutes sale of software which is exigible to tax under the provisions of the Act if the assessee is terming

this transaction as services. Further, he pointed out the letter dated 19.06.2008 of the assessee which shows that they are involved in development of software. They have admitted that 25% of the work in ERP implementation constitutes development of software. In view of the said admission, at least 25% of the consideration paid under the agreement should be treated as sales and tax is leviable under the Act.

8. The learned counsel for the assessee, Sri. Madhava Rao, pointed out that, deliverable materials do not include commercially available software or hardware which are provided under separate agreements. The deliverable materials are not marketable. They are not goods available in the market. It is client specific and they intend making the Baan ERP functional to meet the requirements of the client. As the ownership of these deliverables vest with the client, in order to see that he does not prevent them from using that knowledge while attending to other clients, these clauses 2.2, 2.21 are entered into. Otherwise, there was no

necessity to introduce those clauses. He further submits that the entire consideration received for providing services to the client have been subjected to service tax as is clear from the judgment of the CESTAT in the assessee's case which is reported in ***2010 (17) STR 317*** which is affirmed by the Apex Court while dismissing the appeal at the stage of admission itself. Therefore, no portion of the consideration received could be attributed to sale of the software and, therefore, he submits the impugned order does not call for any interference.

9. In so far as the argument that they have admitted by their letter 25% represents the sale is concerned, he submits when they were called upon to state what portion of the said consideration relates to the contract in ERP implementation they have answered by saying '25%'. It is not a payment which represents the sale price. The Tribunal on consideration of the entire material on record has recorded a finding of fact that, whether tangible or intangible, there cannot be a sale or works contract. Unless

the said finding is shown to be perverse or based on no evidence, the question of interfering with the said finding of fact would not arise in view of the judgment of the Constitution Bench of the Apex Court in ***HINDUSTAN PETROLEUM CORPORATION LIMITED vs DILBAHAR SINGH [JT 2014 (9) 543].*** Therefore, he submits no case is made out for interference.

10. The Tribunal after referring to the stages in which the ERP software is developed held that configuration is the process under which the developed software purchased by the client is loaded to the system of the client to install the same. In this process certain codification are made to the client's software, so that the client's system accepts it and that codification is done to the existing system of the client and no new software is developed. It held that software cannot be developed without following the 10 stages as referred to in the written submission of the learned State representative. In the instant case such a process of developing software does not take place. The ERP

implementation contract is pure service contract as clarified in the circular issued by the CCT and such service would not involve any transfer of property in goods. The technical information provided by the assessee regarding the job of ERP implementation shows that no software is developed by the assessee. Whatever codification is done in the existing system of the customer, it is useful only to the customer and it cannot be transferred to others nor it can be sold to others. There are a variety of branded software relating to ERP in the market. SAP software is one such. Such software is not designed exclusively for use by a particular type of enterprise/business. Such software is designed to use by a large variety of different types of enterprises. By its very nature such a software needs to be made suitable for use by the concerned purchaser of such software. To do so, the software has built in gaps which are in the nature of virtual switches. Where certain machine instructions in machine readable form need to be inserted by any qualified professional to disable all options except the one which suits

the concerned customer that option is enabled. There are several such gaps which require such insertions by qualified professionals to enable the general software to be converted into a specific software designed to serve the needs of the particular customer. ERP implementation specialists do nothing more than fill up those gaps in a branded standard software. The writing up of a code and insertion thereof in the existing gaps in the branded software is all that is done by the assessee's employees in the course of implementation of ERP software. The job description exists of what the assessee is required to do with the software already purchased by the concerned customer. User rights over that software vest in the customer. The codes which the assessee's professionals insert in that software are not proprietary codes having a marketability of their own which the concerned customer can possess or transfer or sell. The moment such machine readable instructions are incorporated in the codes in the standard ERP software purchased by the concerned customer, the concerned

customer acquires full rights over the use of those codes. It is not as if the assessee has put those codes on a Disc or Tape or any other media and kept that media itself for sale which the concerned customer may purchase and transfer it on to the ERP software already purchased by him. In the instant case, the customer does not have goods in the form of a branded ERP software purchased from the market which is embedded in a tangible medium like a C.D. But unless what the assessee adds or accretes thereto are also having the attributes of goods on the basis of the criteria laid down by the Supreme Court in the case of ***TATA CONSULTANCY SERVICES VS. STATE OF A.P.*** reported in ***(2005) 1 SCC 308***, it is inconceivable that a works contract involving transfer of property in goods can come into existence. What the assessee adds by way of machine readable instructions inserted in the gaps in the proprietary ERP software purchased by the customer/client before hand does not constitute goods because those instructions are not described in the contract between the assessee and the

concerned customer/client. Those instructions are not capable independently of being possessed, marketed or transferred by the customer to anyone else. On the contrary ERP software installed could be deleted at a click of button needs to be considered at this juncture. There is no marketable commodity in existence to be sold and unless such commodity whether tangible or intangible exists there cannot be a sale or works contract. Therefore, they proceeded to set aside the order passed by the lower authorities and granted the relief.

11. In this regard this Court had an occasion to consider almost identical issue in the matter which was heard along with this Revision Petition in ***W.P. Nos. 57023-57070/2013*** in the case of ***INFOSYS LIMITED vs THE DEPTUTY COMMISSIONER OF COMMERCIAL TAXES (AUDIT-4.4) AND OTHERS*** decided on ***9.2.2015***. After considering several judgments relied on by the parties, the law on the point has been summarized as under : -

24. The packaged, readymade, off the shelf software are pure goods liable only to VAT. The customized software or tailor made software for an individual customer, similar to packaged software, where the copyright owned software is put on the media and delivered by way of transfer of right to use, will also be goods and is liable to VAT. In the case of customized software, the customized portion is embedded to the original software so as to become the customized software, the copyright of the entire software including the customized portion is exclusively owned by the developer of the software. Therefore, in both packaged and customized software, where copyright is held by the developer of software and the copyrighted article alone is handed over to the customer as a transfer of right to use goods, the software is goods and liable to VAT alone.

25. However, in the case of customized software, it is possible for an entity to work on a hired contract basis rendering pure service and get delivered fully developed software for a specified customer with future contracts for upgradation and enhancement. In such a

situation too, the software emerges. However, the copyright in such software belongs to the customer, as it is developed, and the developer of the software does not retain any copyright in such software. In such a situation, since there is no transfer of property in goods and what is provided is only a pure service, there can be no liability to VAT. The consideration in such cases is liable only to service tax.

26. In the case of Annual Technical Support (ATS), if the agreement of the contract includes the annual maintenance involving both service and issuing upgraded or enhanced software, then such a contract is a combination of both goods and service. The contract is in the nature of works contract. VAT is liable to be paid on the goods part and service tax is to be paid on the labour aspect. In upgradation and enhancement, the copyright is owned by the developer of software and what is transferred to the customer is the right to use.

27. In the case of implementation of customized software, where the copyright of the customized software is with the software developer, the

implementation process is a pure service rendition and does not involve any transfer of property. If any source coding or scripting is done during the process of implementation, the ownership or copyright or any proprietary right would not vest with the software developer. It works purely as a hired labour. The ownership vests at all point of time with the employer who had issued the assignment. In those circumstances, since there is no transfer of ownership or the licence to use the software (deemed sale), it is a pure service contract. There is no sale of goods. It is a case of rendering service and is liable to service tax only.

12. Admittedly, in this case, the integration process of the developed ERP software is undertaken by the assessee by deputing ERP implementation team to render ERP implementation service. What this team does is, they install the ERP software, integrate it and implement at the client's end. This implementation is performed not only by the assessee's personnel but also along with the employees of the client. The members of the ERP Software implementation team of the assessee play various roles in the ERP software

implementation process depending on their skills. The team with the skill ensures that the ERP software is appropriately integrated in the system of the client. In the process the experts will take all necessary steps to provide functional data for the installation of the ERP software and it becomes useful for the client. In the process there is no transfer of any goods involved. Unless the goods is in existence and deliverable so that the right in the goods is transferred, VAT is not attracted. There is no marketable commodity in existence to be sold. Unless such a commodity, whether tangible or intangible, exists there cannot be a sale. The argument of the learned Advocate General relying on clause 2 of the agreement which deals with deliverable materials makes it very clear that no right is retained in the deliverable materials by the assessee and the same vest with the client. What is sought to be clarified in the said clause is, when in the course of implementation even if any software comes into existence, the title of the software vests with the client and not with the assessee. What the assessee is entitled to is the

consideration for the services rendered. In this context it is to be pointed out that the said deliverable materials do not constitute commercially available software, the said deliverable materials are not marketable. They are not goods available in the market. It is client specific. The said materials are required to make the ERP functional to meet the requirements of the client. As the ownership of these deliverables vest with the client, in order to see that it does not prevent them from using that knowledge while attending to other clients, the aforesaid clauses 2.2 and 2.21 in the agreement are entered into. The entire consideration received for providing services to the client have been subjected to service tax. Therefore, no portion of the consideration received could be attributed to sale of the software. Therefore, the finding recorded by the Tribunal is based on legal evidence and supported by the legal position as declared by the Apex Court in several judgments referred to in the order. In that view of the matter, we do not see any merits in this revision petition. Therefore, the questions of

law are answered in favour of the assessee and against the revenue. No arguments were canvassed in respect of Business Consultancy Services rightly.

Hence the revision petition is dismissed.

Sd/-
JUDGE

Sd/-
JUDGE

Hkh/ckl/-