HIGH COURT OF KARNATAKA

Sasken Communication Technologies Ltd.

v.

Joint Commissioner of Commercial Taxes (Appeals)-3 Bangalore*

N. KUMAR AND RAVI MALIMATH, JJ.

Writ Appeal Nos. 90-113 and 118-129 of 2011 (T-RES)

APRIL 15, 2011

Section 65(53a) of the Finance Act, 1994, read with section 4 of the Karnataka VAT Act, 2003 - Information Technology Service - April, 2009 to March, 2010 - Assessee entered into agreements with its clients for development of software - Assessee provided its staff who were well-trained in field and who would develop software according to specification of customer - In terms of agreement even before development of software assessee had given up all rights and claims of software to be developed and had expressly agreed that such a software which may come into existence at end of contract period was absolute property of customer - Whether above contract in question did not indicate sale of any software but a contract for service simplicitor - Held, yes - Whether, therefore, assessment order passed by authorities levying VAT on assessee for above activity was to be set aside - Held, yes [Para 51] [In favour of assessee]

FACTS

The assessee was engaged in the business of software development and export and providing software services. The assessee was a registered dealer under the Karnataka Value Added Tax Act, 2003 and the Central Sales Tax Act, 1956. The assessee had been filing its VAT returns. The assessee was also registered under section 69 of the Finance Act, 1994 for the purpose of payment of service tax and had been paying service tax on its service turnover from the date of its applicability. The Commercial Tax Officer (CTO) visited premises of the assessee and took the assessee's case for audit. On verification of monthly return of the assessee, it was observed that the assessee had provided software development service and claimed exemption on export of same. It was also found that in addition to export of software, the assessee had also rendered services to different parties in respect of development of software. The CTO observed that said development activity of software attracted tax under 'works contract' as per section 4(1)(*c*) of KVAT Act. Accordingly, show-cause notice was issued to the assessee proposing to re-assess under section 39(1) of KVAT Act for period April 2009 to March 2010. The assessee submitted that software development service provided by it will be covered under section 65(105)(*zzzze*) of the Finance Act, 1994. Hence, same was liable to service tax and the payment or levy of VAT on the same did not arise. The assessing authority rejected plea of the assessee and upheld the demand on the assessee along with interest and penalty. Aggrieved by the said order, the assessee preferred a writ petition

before the High Court. However, the Single Judge was of the view that whether the contract in question is a service contract or not and whether if it is a works contract, it is not possible to come to any definite conclusion unless each agreement between the parties is carefully examined. Moreover, a statutory appeal is provided against the impugned order. In that view of the matter, he declined to entertain the writ petitions and dismissed the same.

On appeal :

HELD

From the reasoning of the assessing authority given in its order, it is clear that the assessee is in the business of creating complete solutions for its clients. It has a comprehensive range of applications, services and solutions. It is a solution provider. It is in the development of software. Its solutions and services are backed by a proven reputation for expert support and high quality. The assessee provides solutions and develops software and the same is carried out on the software of the client company. The transfer of property from the technicians of the assessee to the client constitute sale of goods in terms of the judgment and, therefore, liable to sales tax. It is the correctness of the said reasoning and finding which is assailed in these proceedings. [Para 19]

The terms of the contract between the assessee and its clients set out above make it clear that the contract is one for rendering service. The assessee is paying service tax levied on the said service rendered, under the provisions of the Finance Act, 1994 which is enacted by the Parliament by virtue of the power conferred on it under article 248 of the Constitution. [Para 20]

Once the Parliament has made a law dealing with this aspect of service by virtue of the residuary power conferred on it by the Constitution, article 248 comes into operation. It declares that the Parliament has exclusive power to make any law with respect to any matter not enumerated in concurrent list of the State Laws. Such power shall include the power to make laws, imposing tax not mentioned in either of these lists. Therefore, in fact, once the Parliament makes a law, it excludes the other Legislatures to make a law in respect of which the Parliament has made law. [Para 21]

The first part of article 254 deals with the laws made by the Parliament and the State Legislature in the field of legislation which is clearly ear marked for them namely, List-1 and List-II. The second part deals with the law made in respect of the Entries in the concurrent list over which both the Parliament and Legislature has power. In List-II, there is no Entry providing for making of a law and imposition of tax on information technology and software. [Para 22]

Admittedly, the entries regarding service do not find a place either in List-II or List-III. The Parliament has the competence to pass a legislation in respect of the same including imposing of tax. It is in furtherance of such a power conferred under article 248 read with Entry 97 of List-I, the said service has been inserted in the Finance Act, 1994. [Para 24]

The Karnataka Value Added Tax Act, 2003 is enacted by the State Legislature by virtue of Entry No. 54 in List II of Schedule VII. [Para 25]

*However, in the Schedule VI to the Karnataka Value Added Tax, 2003, under the heading of works contract 'the programming and providing of computer software' is included. The Schedule VI came into effect by Act 4 of 2006 with effect from 1-4-2006. In Schedule VI to the said Act with effect from 1-4-2006, tax is sought to be levied on sale or purchase of goods involved in works contract. One such works contract which is specified in Schedule VI is programming and providing of computer software. Therefore, if the works contract of programming and providing of computer software involves apart from agreement of service, the agreement to sell the goods, the State Legislature can levy tax on such goods. It is after the introduction of Schedule VI on 1-4-2006, the Finance Act, 1994 was amended by inserting section 65(105)(*zzze*) with effect from 16-5-2008 providing for service in relation to information technology software for using in the course of furtherance of business or commerce including development of information technology software, study, analysis, design and programming of information technology software. Information and technology software includes computer software. In other words, programming and providing of computer software prescribed in Schedule VI now forms part of section 65(105)(*zzze*). However, it is well-settled that there is no prohibition in law to impose a tax both by the Parliament and the State Legislature on different aspects. In other words, on the aspect of service, the Parliament can levy tax and on the aspect of sale of goods, the State Legislature has the power to levy tax. [Para 28]*

Wherever legislative powers are distributed between the Union and the States, situations may arise where the two legislative fields might apparently overlap. It is the duty of the Courts, however, difficult it may be, to ascertain to what degree and to what extent, the authority can deal with matters falling within these classes of subject exists in each Legislature and to define, in the particular case before them, the limits of the respective powers. It could not have been the intention that a conflict should exist; and, in order to prevent such a result the two provisions must be read together, and the language of one interpreted, and, where necessary modified by that of the other. From time to time that legislation, though purporting to deal with a subject in one list, touches also on a subject in another list, and the different provisions of the enactment may be so closely intertwined that blind observance to a strictly verbal interpretation would result in a large number of statutes being declared invalid because the Legislature enacting them may appear to have legislated in a forbidden sphere. In such circumstances, the true nature and character is to be ascertained for the purpose of determining whether it is legislation with respect to matters in this list or in that list. It is popularly known as 'pith and substance'. The law 'with respect to' a subject might incidentally 'affect' another subject in some way; but that is not the same thing as the law being on the latter subject. There might be overlapping; but the overlapping must be in law. The same transaction may involve two or more taxable events in its different aspects. But the fact that there is an overlapping does not detract from the distinctiveness of the aspects. The true nature and character of the legislation must be determined with reference to a question of the power of the Legislature. The consequences and effect of the legislation are not the same thing as the legislative subject-matter. What matters is the nature and character of the legislation and not its ultimate economic results. [Para 30]

Therefore, if computer programming and providing of computer software involves two aspects, one falling within the power of the Parliament and the other falling within the power of the State Legislature to enact the law, the law so enacted cannot be found faulted with. When the programming and providing of computer software is treated as works contract, as the works contract necessarily involves an agreement to render service and an agreement for sale of goods, service aspect could be taxed by the Parliament and the sale of goods aspect

could be taxed by the State Legislature. But, this distinctiveness of two transactions is to be ascertained from the terms of the composite contract. If such an intention is not discernible from the terms of the contract, then one has to find out what is the pith and substance of the contract or, in other words, what is the true nature and character of the contract. If on an examination of the contract as a whole, it is not possible to discern that the contract involves sale of goods but is essentially an agreement to render service, neither the concept of a works contract nor the concept of aspect theory is attracted. It is by virtue of Entry 54 in List II of the Schedule VII, the Karnataka Value Added Tax is enacted by the State Legislature, as the State Legislature is competent to enact laws in respect of sale of goods. By introducing a schedule to the said enactment and describing under a works contract 'programming and providing a computer software is specified', unless the said works contract involves an element of sale of goods, the State Legislature has no power to levy tax under the said Act. Similarly, the Parliament also has no power to levy service tax on sale of goods by including in the Finance Act, development of information technology software, study, analysis, design and programming, information technology software and various other aspects touching software if it involves sale of goods. It has to be necessarily confined to the service aspect. In both the enactments, they specify the types of activities which are liable for tax. A duty is cast on the Court to interpret those provisions in such a harmonious way so as to uphold the right of both the legislations to levy tax which fall within their respective sphere. [Para 31]

Deemed sale

The Forty sixth amendment to the Constitution carved out exceptions to the law declared by the Supreme Court and introduced the concept of 'deemed sale' to enable the States to levy tax on the sale aspect. The Forty sixth Amendment to the Constitution which introduced clause (29A) to Article 366 specifically provided for those types of cases where, in respect of the very same transaction, both the State Legislature as well as the Parliament can make law. [Para 32]

In a works contract, splitting of service and supply of goods has been constitutionally permitted by introducing the concept of deemed sale. Therefore, the works contract in truth, represents two distinct and separate contracts which are discernible as such. Then the State would have the power to separate the agreement to sell from the agreement to render service, and impose a tax on sale. Therefore, the works contract is necessarily a composite contract, consisting of both an agreement to sell goods and an agreement to render service. No one can deny the legislative competence of the States to levy sales tax on sales provided that the necessary concomitants of a sale are present in the transaction and the sale is distinctly discernible in the transaction. This does not, however, allow the State to entrench upon the union list and tax services by including the cost of such service in the value of the goods. [Para 33]

Therefore, the legislative intention is that the expression of 'sale of goods' in Entry 54 should bear precise and definite meaning it has in law, and that the meaning should not be left to fluctuate with the definition of sale, in a law relating to sale of goods, which might be in force for the time being. If the words 'sale of goods' has to be interpreted in their legal sense, that sense can only be what it has in the law relating to sale of goods. The ratio of the rule of interpretation that words of legal import occurring in a statute should be construed in their legal sense is that those words have, in law, acquired a definite and precise sense, and that, accordingly, the Legislature must be taken to have intended that they should be understood in that sense. Therefore, while interpreting an expression used in a legal sense, one has only to

ascertain the precise connotation which it possess in law. In India, to constitute a transaction of sale there should be an agreement, express or implied, relating to goods to be conveyed by passing on title in those goods. It is the essence of this concept that both the agreement and the sale should relate to the same subject-matter. Where the goods delivered under the contract are not the goods contracted for, the purchaser has a right to reject them, or to accept them and claim damages for breach of condition. Therefore, in law, there cannot be an agreement relating to one kind of property and sale of different property. On the other hand, there must be a definite agreement between the parties for the sale of the very 'goods' in which eventually property passes. To sum up, the expression 'sale of goods' in Entry 54 is a nomen juris*, its essential ingredients being an agreement to sell movables for a price and property passing therein pursuant to that agreement. [Para 34]*

The essential test to be satisfied before an article is said to be 'goods' is the test of marketability. In the market, the said 'goods' is to be known as a commodity which is useful to a customer. In other words, it should be known to the market as goods. That is, such goods must be bought and sold in the market. Therefore, an article or commodity or a material must be something which can ordinarily come to the market to be bought and sold. It must have a distinctive name, character or use. Thereafter, it should satisfy the test of abstraction, transmission, transfer, delivery, storage and possession, etc. [Para 35]

*The forty-sixth Amendment does not give a licence, for example, to assume that a transaction is a sale and then to look around for what could be the goods. The word 'goods' has not been altered by the Forty-sixth Amendment. That ingredient of a sale continues to have the same definition. By introducing separate categories of 'deemed sales', the meaning of the word 'goods' was not altered. Transactions which are mutant, sales are limited to the clauses of article 366(29A). Apart from cases falling under sub-clause (*b*) and (*f*) of clause (29A) of article 366, there is no other service which has been permitted to be so split. If there is an instrument of contract which may be composite in form in any case other than the exceptions in article 366(29A), unless the transaction in truth represents two distinct and separate contracts and is discernible as such, the State does not have the power to separate the 'agreement to sell' from the 'agreement to render service', and impose tax on the sale. The question is did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention, there is no sale even if the contract could be disintegrated. The test for deciding whether a contract falls into one category or the other is as to what is the substance of the contract. The seller and such purchaser would have to be* ad idem *as to the subject-matter of sale or purchase. In arriving at a conclusion, the Court would have to approach the matter from the point of view of a reasonable person of average intelligence. [Para 36]*

The test for deciding whether a contract falls into one category or the other is as to what is 'the substance of the contract' i.e.*, the dominant nature of the contract. The test therefore for composite contracts other than those mentioned in article 366(29A) continues to be, did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale even if the contract could be disintegrated. In order to attract sales tax, it should fall within one of the exceptions provided under the aforesaid provision. If the contract entered into is not a works contract, then that would not fall under any of those exceptions or under the above provision. Therefore, it is necessary to look into the terms of the contract carefully to ascertain the true intent and nature of the contract, what is the nature of activity, what the parties intended, what is agreed upon and what is the consideration paid. [Para 38]*

Nature of Contract

From the clauses of contract entered into between the assessee and its clients, it is abundantly clear that the parties have entered into an agreement whereby the assessee would render service to the client for development of software, Pursuant to the agreement and the work orders, the service shall be performed by the assessee. Services must be requested by issue of a valid work order together with a statement of work. [Para 39]

The assessee agrees, that all patentable and unpatentable, inventions, discoveries and ideas which are made or conceived as a direct or indirect result of the programming or other services performed under the agreement shall be considered as works made for hire and shall remain exclusive property of the client and the assessee shall have no ownership interest therein. Promptly, upon conception of such an invention, discovery, or idea, the assessee agrees to disclose the same to the client and the client shall have full power and authority to file and prosecute patent applications thereon and maintain patents thereon. At the request of the client, the assessee agrees to execute the documents including but not limited to copyright assignment documents, take all rightful oaths and to perform such acts as may be deemed necessary or advisable to confirm on the client all rights, title and interest in and to such inventions, discoveries or ideas, and all patent applications, patents, and copyrights thereon. Both the source code of developed software and hardware projects of worldwide intellectual property in and each shall be owned by the client. The assessee acknowledges that all deliverables shall be considered as works made for hire and the client will have all right, title including worldwide ownership of intellectual property rights in and each deliverable and all copies made from it. If acceptable to the client, the client may reuse all or any of the components developed by the assessee outside the scope of those contracts which are for the execution of the projects under that agreement. [Para 40]

Therefore, even before rendering service, the assessee has given up his rights to the software to be developed by it. The consideration under the agreement is not for the cost of the project, the consideration is for the service rendered, based on time or man hours. Once the project is developed, all rights in respect of the said project including the intellectual property rights vest with the customer and he is at liberty to deal with it in any manner he likes. The assessee has agreed to execute all such documents which are required for the exercise of such absolute rights over the software developed by the assessee. [Para 41]

The term 'deliverables' has been defined under the agreement to mean all materials in whatever form generated, treated or resulting from the development including but not related to the software modules or any part thereof, the source code and/or object code, enhancement applications as well as any other materials, media and documentation which shall be prepared, written and/or developed by the developer for the client under this agreement and/or project order. If the customer agrees to provide any hardware, software and other deliverables that may be required to carry out the development and provide the deliverables, he may do so. Otherwise the assessee has to make or provide all those hardware and software to develop the deliverables and the final product. No doubt at the end of the day, this software which is developed is embedded on the material object and only then the customer can make use of the same. The software so developed even before it is embedded on the material object or after it is embedded on a material object exclusively belongs to the customer. In the entire contract, there is nothing to indicate that the assessee after developing the software has to embed the same on a material object and then deliver the same to the customer so as to have title to the project which is developed. The title to the

project/software to be developed lies with the customer even before the assessee starts rendering service. [Para 42]

In the agreement or from any other material on record, there is nothing to indicate that the assessee purchases the software from the market, improves the same according to the specification of the client and then delivers the same to the client. On the contrary, the agreement clearly discloses that the assessee's technicians either work at their office or go to the place of the client, carry out the project work and find solutions and if at the end of the day, any software emerges, same is embedded on a CD. The software so developed, from the inception is the property of the customer. At no point of time, the said software is the property of the assessee. Even before the software/goods came into existence, it was the property of the customer. The terms of the contract as set out above, do not indicate sale of any software. On the contrary, those terms make it very clear that the agreement is a simple service contract, whereunder the assessee provided its staff and its employees who were well-trained in the field and who would develop the software according to the specification of the customer. [Para 43]

In fact, a careful reading of the agreement shows that the employees of the assessee and the employees of the customer have to work hand in hand, consult at every stage, have interactions and understand the need and requirement of the customer and through their employees, the software is to be developed. The technicians of the assessee and the employees of the customer are working together at the project site. In most of the cases, the service rendered by the assessee is in the nature of making one of the inputs into a final product which is produced at the project place with the assistance of the staff of service providers. In fact, the material on record discloses that the customers have engaged the services of several service providers, who have expertise in different fields and all of them put their mind and hands together and find a solution to the problem of the customer. The end product i.e.*, the ultimate software, is not necessarily the work of any one such service provider. It is a collective effort. Nobody can claim that the end product exclusively belongs to them except the customer who has paid for the service rendered by various service providers. [Para 44]*

As clear from the terms of the agreement, on the day they entered into agreement, there was no software in existence. In other words, there was no goods in existence. The agreement is not for transfer of software. The agreement is for development of software. Even before the software comes into existence, the assessee had given up all the rights and claims of the software to be developed and had expressly agreed that such a software which may come into existence in end of the contract period is the absolute property of the customer. The customer is at liberty to deal with that software in the manner he wants without further reference to the assessee. The consideration paid is not for transfer of any goods. The consideration paid is calculated in terms of time such as man days, man hours and man months. As on the date of entering into the contract, both the parties are not clear how much time the contract would ultimately take and when the end product, i.e.*, the software is produced. [Para 45]*

Intellectual property comprises of all those things which emanate from the exercise of the human brain, such as ideas, inventions, poems, designs, etc., The word 'property' comes from the Latin word proprius*, which means 'one's own'. Intellectual property means, the legal rights which may be asserted in respect of a product of human intellect. The fruits of intellect would exist even if they enjoyed no legal protection. [Para 46]*

Intellect is not property by itself. Through intellect, one can create intellectual property. It is that intellectual property that will become 'goods' once put on a medium for sale. Intellectual property does not exist in the mind of the technician. What exists in his mind is the intellect. Using that intellect, a technician creates or develops 'goods'. It is that goods which is called intellectual property when put on a medium for sale. Therefore, when a technician creates or develops an intellectual property, there is no element of transfer involved. When such intellectual property is put on a medium for sale, it is capable of being transferred. If transfer takes place, then, it constitutes sale of goods. [Para 47]

When a customer gives a software related problem to the technician, to find a solution, if the assessee has a ready made answer, in the form of a ready made software, such software is goods. It may be branded or unbranded software. All that the assessee has to do, is to transfer the goods. Then it amounts to sale of goods. On the contrary, if the assessee has no ready made answer, he has to find an answer by using his intellect or of his employees and has to work on the problem using his intellect. That process is called development or creativity. In the end, when he finds a solution to the problem, it means, he has created or developed a software. That software is the intellectual property and will become goods if put on a medium for sale. [Para 48]

The easiest way to protect intellectual property is to keep it in one's head. If a person possesses in his head a good idea, there is no risk that any one will see or find it, and thereby appropriate it. Such intellectual property may be preserved thus until its owner chooses to divulge it. If the idea consists of a process of doing some thing it even remains securely in the possession of its owner if he performs that process when no one sees him performing. The possessor of such property can take it to the grave with him, safe in the knowledge that no one will inherit it. There is relatively little potential for the commercial exploitation of intellectual property while it remains in his head. This is because the keeping of an idea to oneself and the commercial utilization of that idea are inherently contradictory notions. The acquirer of an intellectual property right can derive no financial benefit from it except by using it commercially. He will gain advantage only by making a product and selling it or by charging others who wish to exploit his intellect. When he offers his services or intellect to an employer, he is not selling any intellectual property as none exists on the date of contract of employment. The employer gets a right to exploit the intellect, according to his needs and requirements and he pays for the services rendered. He is not purchasing any intellectual property for the purpose of exploiting the same, as none exists on the date of contract of employment. When an employer hires technicians and pays them salary, a relationship of employer and employee comes into existence. The employer may utilize the services of the technicians for his personal use. He may also lend their services to others, who are in need of them. He may also employ them in the job he has undertaken to execute. In all these cases, the technicians are rendering their service by applying their intellect. They are paid for the services rendered. In consideration of the remuneration received, they are not selling any intellectual property to any one. They are not in the business of sale of intellectual property. Similarly, their employer is also not in the business of sale of any intellectual property. On the other hand, they are in the business of rendering service to develop intellectual property or software. Therefore, there is no element of sale involved at any stage of the transaction. The intellectual property developed by the technicians in the course of employment and the intellectual property developed in the course of executing service contract do not belong to the technician or the employer. From the inception of the contract, it is the property exclusively belonging to the customer. It is in the nature of an unbranded software. It is client specific. It may be of no use to others. It is not bought and sold in the market. It has no

distinctive name or character. It is not known as a commodity in the market. The terms of the agreement between the parties give no indication of a sale or purchase of this software. On the contrary, in the entire agreement what is agreed upon is providing the service. [Para 49]

In the light of the aforesaid discussion, the finding recorded by the assessing authority that the contract in question involves a sale of software development by the assessee cannot be sustained. It is contrary to the material on record, the constitutional provisions and the law declared by the Apex Court. Accordingly, it is hereby set aside. [Para 50]

Alternative remedy

It was contended that against the order passed by the assessing authority, a statutory first appeal and against that appeal, a statutory second appeal is provided and, therefore, the Single Judge was justified in directing the parties to approach the appellate forum and the court should not entertain these appeals. Normally, when the statute provides an alternative remedy by way of an appeal, High Court declines to entertain a writ petition against such assessment orders, but, it is not an invariable rule specifically when the case involves interpretations of constitutional provisions and when the authorities have already interpreted these provisions in a particular manner, the question of the party approaching the very departmental authorities would make no difference. That apart, these assessment orders are passed after coming into force of the Finance Act, 1994 and when service tax was imposed. The question for consideration is, when once by a parliamentary legislation, service tax is levied on the entire consideration received by the assessee, whether it is open to the State Legislature to levy sales tax on any portion of the said consideration which has already suffered service tax. Even otherwise also, the question for consideration is as discussed above, whether the contract in question is an indivisible contract or a composite contract and even if it is a composite contract, what is the dominant nature of the contract. These are matters which require to be interpreted by the High Court. It will have an effect not only on the assessee before the Court, but to all the assessees who are similarly placed in the State, so that the law is settled and assessment orders to be passed by the authorities would be in accordance with law. Therefore, there is no merit in the contention that merely because an alternative remedy is provided against these orders by way of statutory appeals, that the High Court should not entertain these writ appeals. Hence, the following order was passed:

(A) Writ appeals are allowed.

(B) The contracts in question are not works contract but contract for service simplicitor. In other words, it is not a composite contract, consisting of contract of service and contract of sale of goods. It is an indivisible contract of service only.

(C) The impugned order passed by the Single Judge and the assessment orders passed by the authorities levying sales tax are hereby set aside. [Para 51]

CASES REFERRED TO

TATA Consultancy Services v. *State of Andhra Pradesh* [2004] 141 Taxman 132 (SC) (para 9), *Advent Systems Ltd.* v. *Unisys Corpn.* 925 F 2d 670 (3rd Cir 1991) (para 10), *Imagic*

Creative (P.) Ltd. v. *CCT* [2008] 12 STT 393 (SC) (para 29) and *Bharath Sanchar Nigam Ltd.* v. *Union of India* [2006] 3 STT 245 (SC) (para 37).

Raghuram and **Chythanya K.K.** *for the Appellant.* **T.K. Veda Murthy** and **Smt. S. Sujatha** *for the Respondent.*

JUDGMENT

N. Kumar, J - These writ appeals are filed against the order passed by the learned Single Judge declining to entertain the Writ Petitions, which is filed challenging the order passed by the assessing authority on the ground that the petitioner has an alternate and efficacious remedy by way of statutory appeal.

2. The appellant-assessee is a Public Limited Company engaged in the business of software development and export and providing software services. The assessee is a registered dealer under the Karnataka Value Added Tax Act, 2003 (hereinafter referred to as the 'KVAT Act') and the Central Sales Tax Act, 1956, (hereinafter referred to as 'the CST Act' for short). The assessee has been filing its VAT returns in Form VAT 100 in LVO - 045 regularly. The assessee is also registered under Section 69 of Chapter-V of the Finance Act, 1994 (hereinafter referred to as the 'Act') for the purpose of payment of service tax and has been paying service tax on its service turnover from the date of applicability. The place of business of the assessee was visited by the Commercial Tax Officer for the purpose of inspection on 8-6-2010. Subsequently the case was assigned for audit. The assessee produced all its books. The Commercial Tax Officer audited the books of account for the period from 2009-10, Subsequently a notice was issued under sections 39(1), 72(2) and 36 of KVAT Act. On 9-8-2010 in the course of verification of the monthly returns it was observed that the assessee has provided software development and claimed exemption on exports. In support of his case he had filed copies of invoices and the purchase orders for verification. In the course of verification it was found that in addition to export of software the assessee has also rendered services to one M/s. Alcatel-Lucent Technologies, (2) M/s. Motorola (3) M/s. Texas Instruments (4) M/s. Nokia. They also noticed that the assessee had entered into agreements with the above Companies regarding the business activities. After setting out the nature of the activities carried out by the assessee, he concluded that the Company dealt in high-end work of' development in various fields and thus executed works contract. This development activity of software attracts tax under works contract as per Section 4(1)(C) of KVAT Act at 4%. As per the provisions of Rule 3(2) of KVAT Rules, 2005, the labour charges @ 25% is allowed as exemption. Verification of VAT 100 filed by the dealer revealed that the exempted sales turnover includes export also. For computation of tax liability the VAT 100's are considered.

3. In the light of the above it was proposed to re-assessee under section 39(1) of KVAT Act for the tax period from April 2009 to March, 2010 month wise based on the information available on records by rejecting the monthly returns filed by the assessee as incorrect and incomplete. It was also proposed to impose interest and penalty. On receipt of the said notice the assessee filed his objections. The assessee submitted that it is in the business of rendering software development service and have been accordingly paying service tax under the Act, on its turnover from the date of applicability. The Company pays service tax under the head "Information Technology Software services." Section 65(105) of Chapter-V of the Act,

includes within its ambit the taxable service in the nature of information technology software under sub-clause (*zzzze*). Given the fact that the Company is providing services and hence liable to service tax, the payment or levy of VAT on the same turnover does not arise. They also pointed out that the observations made in respect of the agreements are incorrect and they have set out in the nature of reply, the nature of services rendered to each of their clients and also pointed out the different clauses in the said agreements. Then they contended that they provide the Information Technology services and the clients owned all the Intellectual Property developed during the course of the performance of the agreement. They have assumed the deliverables only as a work for hire. At no point of time the assessee owns in any manner whatsoever any copyright or any other right in the work. Obviously the assessee cannot sell what it does not own. Hence there cannot be any transfer of property in goods. They contended that the assessee provides only services under the agreement and the service is solely related to information Technology software services. The assessee never owns at any point of time any intellectual Property or inventions or discoveries or new developments made during the course of the performance of the agreements. All the Intellectual Property or Inventions or discoveries or new developments are the exclusive property of the customer at all times. The assessee has contracted under the agreement to render services as per the specifications of the customer and hence did not have ownership of any software developed under the agreements. Their case squarely falls within the circumstances described in Part-(4) of the Circular No. 17/2006/07 issued by the Commissioner of Commercial Taxes. They have extracted the Circular. Therefore they sought for dropping of the proceedings.

4. However on consideration of the aforesaid material the assessing authority in the impugned order has held that whether the assessee Company is a software development-Company making deemed sale of software or they are mere service providers or solution providers has to be understood on the strength of the agreements with the client Companies. The agreements specify the deliverables/customers/maintenance etc., the meaning of these are nothing other than the code writing or further development of the software. Irrespective of the mode of payment as either lump sum/based on man hours the entire receipts are towards the development of software only. There has been a misconception in the understanding of the Circular issued by the Commissioner of Commercial Tax (Karnataka), Bangalore. The sum and substance of development of software either in the Company's premises or elsewhere will end up through the deliverables. The objections filed are found to be general in nature and they are not supported by the provisions of the Act nor any Judgments to prove credence. So the objections filed were rejected. The only explanation of reversal of turnovers was considered as per the books of account. Therefore ultimately they upheld the demand and also imposed interest and penalty. Aggrieved by the said order the assessee preferred a Writ Petition before this court.

5. However the learned Single Judge was of the view that whether the contract in question is a service contract or not and whether if it is a works contract, it is not possible to come to any definite conclusion unless each agreement between the parties is carefully examined. Moreover a statutory appeal is provided against the impugned order. In that view of the matter, he declined to entertain the Writ Petitions and dismissed the same. Aggrieved by the said order the assessee is before this Court in appeal.

Rival Contentions

6. The learned counsel appearing for the assessee contended that the contract in question is a contract of service simplicitor. There is no element of sale in the execution of contract

between the parties. The assessee has paid the service tax in respect of the entire consideration, received under the agreement. Therefore, once the field is covered by the Central Legislation, the Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List, the State has no power to enact a law or transgress the law enacted by the Parliament and levy tax under the guise that it involves sale of goods. As is clear from the terms of the agreement entered into between the parties there is no sale of any goods or deemed sale. The reliance placed by the assessing authority on the balance sheet to contend that in execution of the contract, as the assessee has purchased the software and the said software is without any substance. Though in the balance sheet the software purchase is shown, the said software is used as a tool by the assessee in executing the contract and the said tools are not transferred. The agreement and the other material on record clearly shows the assessee has rendered its services to find a solution to the problem of the customer and even before the said solution is found, the assessee has given up his right in the copyright or the proprietary right in such goods, which may emerge as a final product and therefore seen from any angle there is no element of sale of goods which attracts sales tax. Therefore he submits that, the order of assessing authority levying sales tax is *ex facie* illegal, one without jurisdiction and liable to be set aside.

7. *Per contra*, the learned Government Advocate supporting the impugned order contended that software is now held to be goods. Though it is intangible or incorporeal, what the assessee does by employing its labour is to produce the customized software and once the end product is put on a material object and transferred to the customer it amounts to sale of software and therefore sales tax is attracted. Even in executing the said contract the software is purchased. It is on the software which is purchased, the developmental activities take place and that value added addition to the software is transferred to the customer. It is a works contract which falls under clause (*b*) of Article 366 (29A). It is a deemed sale which attracts the sales tax and therefore no case for interference is made out.

8. From the aforesaid facts and rival contentions, the point that arise for our consideration in these appeals is as under:

"Whether the contract for development of a software fails within the mischief of a "works contract", and when the software so developed, vests with the customer from day one does it amount to deemed sale under Article 336(29-A) (b) of the Constitution of India?"

Is it a works contract

9. On behalf of the revenue, it was contended that, a Constitution Bench of the Apex Court in the case of *Tata Consultancy Services* v. *State of Andhra Pradesh* [2004] 141 Taxman 132 has held that software is a goods which is capable of being bought and sold, capable of abstraction, consumption and use and can be transmitted, transferred, delivered, stored, possessed etc., as such, in a contract for rendering service to develop a software, when the software is transferred to the customer, it amounts to sale of goods and liable to sales tax.

10. The question which arose for consideration in *Tata Consultancy Services* is, whether the canned software sold by the assessee can be termed to be "goods" and as such assessable to sales tax under the Act.

The Apex Court relied on the judgment of the American Corporation in the case *Advent Systems Ltd.* v. *Unisys Corpn.* 925 F 2d 670 (3rd Cir 1991) where it was held that, computer

programs are the product of an intellectual process, but once implanted in a medium they are widely distributed to computer owners. An analogy can be drawn to a compact-disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a "goods", but when transferred to a later-readable disc it becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not goods, but, when transcribed as a book, it becomes goods. That a computer program may be copyrightable as intellectual property does not alter the tact that once in the form of a floppy disc or other medium, the program is tangible, movable and available in the market place. The fact that some programs may be tailored for specific purposes need not alter their status as "goods" because the definition includes "specially manufactured goods".

Thereafter, at para 24, they proceeded to hold as under :

"In our view, the terms "goods" as used in article 366(12) of the Constitution of India and as defined, under the said Act are very wide and include all types of movable properties, whether those properties be tangible or intangible. A software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it he in the form of books or canvas (in case of painting) or computer discs or cassettes, and marketed would become "goods". We see no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc of the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media, *i.e.,* the paper or cassette or disc or CD. Thus, a transaction sale of computer software is clearly a sale of "goods" within the meaning of the terms as defined in the said Act. The term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed, etc. The software programmes have all these attributes."

"In so far as the distinction between a branded and unbranded software is concerned, it was held in both cases, the software is capable of being abstracted, consumed and used. In both cases the software can be transmitted, transferred, delivered, stored, possessed, etc. 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 or contract of sale and/or whether the contract is a service contract may arise".

11. From the aforesaid judgment, it is clear that a software is "goods" as defined under Article 366(12) of the Constitution of India and therefore, there is no dispute about the said legal position. But the question for consideration in these cases is, whether a contract that is entered into for developing a software, is it a service contract or a composite contract including service and sale of goods.

12. The Apex Court after holding that even unbranded software when it is marketed/sold, may be goods, made it very clear that, in the aforesaid decision, they are not dealing with this

aspect and expressed no opinion because in case of unbranded software "whether the contract is a service contract" or "contract of sale is also involved", may arise. That is precisely the question that has to be decided in these cases. Therefore, the said judgment do not come in the way of this Court going into the said question, as the Supreme Court has not expressed their opinion on the said issue. Therefore, the field is open.

13. In order to justify the imposition of value added tax, the revenue contends that it is a composite contract, a works contract. There is an element of service and transfer of goods, consequently a deemed sale.

14. The word 'works contract' has been defined under the Karnataka Value Added Tax Act, 2003 as under:

"Works contract" includes any agreement for carrying out for cash, deferred payment or other valuable consideration, the building, construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair or commissioning of any movable or immovable property,"

15. The revenue contends, works contract includes an agreement for improvement. In other words, their case is, the assessee has purchased software from the market. Then the said software is improved by rendering service according to specification to meet the requirements of the client. Then the software so developed is embedded in the software which is on a media and then transferred to the customer. Therefore, there is a deemed sale. If the material on record discloses as a matter of fact that the assessee purchased software embedded on a media which is admittedly goods, and any improvement is made on such goods and then sold to the customer, may be it fells within the definition of a "Works contract". But in the entire agreement between the parties, there is no indication to support the said contention. In fact, reliance is placed by the revenue not on the terms of the contract, but on the balance sheet. The balance sheet in these cases disclose that the assessee has incurred an expenditure of Rs. 183.19 lakhs towards software expenses, which according to the revenue is the consideration paid by the assessee for purchase of software. The assessee points out, in the very balance sheet, they have spent a sum of Rs. 21,404.07 lakhs towards salaries and bonus. It is the specific case of the assessee that the software expenses referred to therein is the software which they have purchased and used as a tool in the development of a software according to the specification of the customer. It is not a software on which they have made any improvement. Having regard to the amount mentioned in the balance sheet, towards salaries and bonus, the amounts spent on purchase of software will be less than 1% of the amount spent on salaries and bonus. Their specific case is that they have developed a software to meet the requirements of their customer, which software at all point of time, exclusively belonged to customer. There is no sale of software involved in the entire transaction.

16. In order to appreciate the rival contentions and to find out whether the contract in question is a works contract, or an indivisible contract, and what is the dominant nature of the contract and what is the intention of the parties, it is necessary to see the relevant and material terms of the contract. The same is extracted hereunder:-

Master Agreement for Services between Motorola India Electronics Private Ltd. and Sasken Communication Technologies Limited.

"1.1 *Definitions*

** ** **

(*b*) "Developed Software" shall mean any software, modifications or enhancements to or derivative works of software and documentation developed as part of Services, pursuant to a Work Order by the Vendor or its agents and sub-contractors.

(*c*) "Intellectual Property" shall mean the legal rights, including intellectual property rights, moral rights or like rights of forms of protection, subsisting in patents, copyrights, trade secrets and trademarks, trade dress, service marks, designs, logos and other intellectual property rights under the laws of India or any other jurisdiction and. all registrations, applications for registration, renewals, extensions, continuators, dividends, re-examinations or reissues or equivalent of any of the foregoing.

** ** **

(*e*) "Services" shall mean software development and other services that the Vendor will provide to Motorola pursuant to this Agreement and the Work Orders.

(*f*) Statement of Work shall mean a document (which may be entitled "Statement of Work" or "Scope of Work" or the like) that has been prepared by Motorola and mutually agreed in writing between the Parties, in relation to a specific requirement and provided to the Vendor that describes the Services required pursuant to a Work Order. The Statement of Work may include, among others, the following:

- Specifications
- Deliverables and schedules from MOTOROLA for each milestone
- Identified Milestones
- Schedule for each milestone
- Deliverable from the Vendor for each milestone
- Resource required for development for each milestone
- Computer systems, software, tools required with date of availability
- Acceptance criteria
- Any other specific condition.

The word 'deliverables' under this Agreement shall mean all outputs generated as per this Statement of Work.

(*g*) "Software" shall mane software and documentation developed by the Vendor under the Agreement

2. Scope of Agreement.

(*a*) This Agreement sets forth the contractual terms for Services to be provided to Motorola by the Vendor. Services will be performed by the Vendor in accordance with Work Orders issued by Motorola and Statements of Work attached thereto.

(*b*) If there are generally accepted services, functions, responsibilities or tasks in the software services industry, which are not specifically described in a Work Order or Statement of Work that are required for proper performance and provision of the Services under such Work Order or Statement of Work, and are an inherent part of, or a necessary sub-part included within such Services, then such services, functions, responsibilities and tasks shall be deemed to be implied by and included within the scope of the Services to the same extent and in the same manner as if specifically described in such Work Order of Statement of Work.

(*c*) The Vendor will provide the Services to Motorola as agreed in the applicable Work Order and the Statement of Work attached thereto. The Vendor will perform the Services requested in each Work Order in accordance with performance measures customarily applied by the Vendor and/or any service levels agreed between the Parties, which may include methodologies such as rates of production of lines of codes, function points, on time performance, customer satisfaction, percentage of defects or other metrics or methodologies.

3. Responsibility of Vendor

** ** **

(*d*) The Vendor will ensure that adequate number of telephone lines, fax and Internet connectivity is made available to the Motorola project team(s) at the Vendor's premises, and in accordance with the norms agreed between the Parties.

** ** **

(*f*) If expressly provided in a Statement of Work, the Vendor shall provide, at its expense, all of the facilities, personnel, equipment, software, services and other resources necessary to provide the Services, including all basic systems (hardware/software/networking equipment/connectivity, etc) required for development of any Software or performance of any Services requested by Motorola. MOTOROLA and the Vendor may identify in detail the hardware, software and infrastructure requirements for project execution in applicable Work Order and/or Statement of Work. The Vendor shall not implement any action or decision regarding such resources that would have an adverse impact on the Services (including, without limitation, changes in equipment software and systems configurations), service level specifications, the amounts payable to the Vendor under any Work Order or other Motorola, costs and expenses, without Motorola's prior written, consent, which consent may be withheld in Motorola's sole discretion.

** ** **

12. Work Orders

12.1 No Services shall be performed for MOTOROLA by the Vendor by virtue of this agreement alone. Service must be requested hereunder through issuance of a valid Work

Order, together with a Statement of Work, Each Work Order will give a. reference to MOTOROLA contract number assigned to this Agreement and shall include the following information.

(*a*) The date of the Work Order;

(*b*) The work order number;

(*c*) Statement of Work, detailed Specification document;

(*d*) List of specific resources required, who and how they would be procured

(*e*) The MOTOROLA project manager,

(*f*) The total hiding limit for the Work Order, if any, and

(*g*) Any special terms and conditions agreed upon by the parties with respect to the Work Order.

12.2 Within ten (10) business days after the Vendors receipt of a mutually agreed Work Order, the Vendor shall accept or reject the Work order in writing and if accepted return a legible copy of the accepted Work Order to MOTOROLA, Provided, however, that if a Work Order fails to provide all required, ordering information or incorrectly states prices or other material information, relative to the Work Order, the Vendor may reject the Work Order by promptly submitting written notice of rejection to MOTOROLA stating in detail the reasons for rejection and the modifications necessary to make the Work Order acceptable to the Vendor. The Vendor shall make no changes, amendments, modifications, additions or deletions to a Work Order without the prior written consent of MOTOROLA. Acceptance of a Work order shall bind the Vendor to comply with the terms and conditions set forth in such Work Order, including delivery dates, time schedules, amounts and other ordering information shown on the Work Order and other supplemental provisions contained therein.

12.3 The effective date of a Work Order shall be the date on which it is accepted, by the Vendor, which has to be either on or after the date the Work Order is released by Motorola.

12.4 Each Work order shall incorporate by reference, and shall be subject to, the terms and conditions of this Agreement This Agreement and each Work Order and the relevant Statement of Work shall be interpreted as a single agreement so that all of the provisions are given as full effect as possible. In the event of a conflict between this Agreement and any Work Order or Statement of Work attached, thereto, the order of preference shall be : (l) this Agreement (2) the Work Order (but only in respect of the Services and deliverables under such Work Order), (3) the Statement of Work (but only in respect of the Services and deliverables specified in such Statement of Work) and (4) any other applicable Schedule to this Agreement.

** ** **

16. Invoices and Payment

16.1 As compensation for the Services, MOTOROLA shall pay Vendor the fees specified in the relevant Work Order and/or Statement of Work. Vendor, in connection with the Services to be performed hereunder, may incur travel expenses at the request of MOTOROLA. All necessary, reasonable and actual travel expenses of Vendor incurred for such travel shall be reimbursed by MOTOROLA, provided that Vendor has obtained MOTOROLA'S prior written approval before incurring any such expenses, and MOTOROLA receives from Vendor an itemized list of all expenses incurred, including the paid receipts therefor, which are to be reimbursed in accordance with the above. No additional costs of any kind may be incurred without the prior written consent of MOTOROLA Vendor shall submit, invoices to MOTOROLA's authorized representative upon completion of and acceptance by MOTOROLA of each, phase of the project as set forth in the relevant Work Order and/or Statement of Work. As specified in each Statement of Work, the parties will agree whether the work will be billed on a time and materials basis or on a fixed price. For time and materials based projects. Vendor shall bill MOTOROLA on a monthly basis. Payment is due net forty five (45) days following receipt of a correct invoice therefore.

16.2 All invoices shall reference the MOTOROLA contract number assigned to this Agreement and the applicable Work Order number and shall be delivered, to the Finance department, Motorola India Electronics Private Limited, No. 66/1, Plot 5, Bagmane Techpark, CV Raman Nagar, Bangalore 560 093.

16.3 Pricing for time and materials projects shall be fixed at a rate set forth in Annexure A. Vendor agrees not to increase the price for twelve months from the effective date of this Agreement. The Parties agree to review prices on an annual basis and to renegotiate as necessary to meet market conditions.

16.4 The fees set forth in the relevant Work Order and/or Statement of Work for the Services and deliverables do not include applicable sales, use, excise, VAT or similar taxes. To the extent Vendor is required by law to collect such taxes, they shall be a separate line item on invoices and paid in full by MOTOROLA, unless MOTOROLA is exempt from such taxes and furnishes Vendor with an appropriate certificate of exemption. The fees set forth in the relevant Work Order and/or Statement of Work for the Services and deliverables do not include applicable customs duties and similar charges. Vendor agrees to provide MOTOROLA with all reasonable documentation and assistance to evidence such costs, including for purposes of MOTOROLA recovering the duties, VAT or similar taxes. Vendor will make every effort to provide assistance to MOTOROLA in eliminating, reducing and recovering any duties, VAT or similar taxes as eligible under the relevant laws and regulations and as deemed appropriate by MOTOROLA. Vendor represents that is shall comply with all applicable tax laws, rules and regulations in fulfilling its obligations under this Agreement.

** ** **

19. Escalation Matrix

A. The Vendor's executive representative (to be identified and attached as addendum to Agreement) and the MOTOROLA executive representative (to be identified and attached as addendum to Agreement) shall attempt to reach an acceptable remedy. If negotiations between the executive representatives are unable to produce an acceptable solution, the non-

compliance issue shall escalate to the senior officer level (general manager, managing director or other officers at same or higher level) of the Vendor and MOTOROLA.

** ** **

27. Risk Management

Specific Risks related to project execution:

The Vendor shall prepare a detailed Risk Plan document, assessing all risks associated with the given project under a Work Order and address each one of the identified Risks. MOTOROLA will approve all actions planned for the Risk management. The Vendor will be responsible for defining the schedules for periodic back up of program and documentation data. This backup plan would include adequate measures to protect development work from hazards like fire, theft and natural calamities to minimize damages.

** ** **

36. Ownership of Products

36.1 Notwithstanding anything to the contrary, the Vendor agrees that all patentable and unpatentable inventions, discoveries, and ideas which are made or conceived as a direct or indirect result of the programming or other Services performed under this Agreement, shall be considered works made for hire and shall remain the exclusive property of MOTOROLA and the Vendor shall have no ownership interest therein. Promptly upon conception of such invention, discovery, or idea, the Vendor agrees to disclose the same to MOTOROIA and MOTOROLA shall have full power and authority to file and prosecute patent applications thereon and maintain patents thereon. Upon MOTOROLA'S request, the Vendor agrees to execute documents, including but not limited to copyright assignment documents, take all rightful oaths and to perform such acts as may be deemed necessary for advisable to confirm in MOTOROLA all right, title and interest in and to such inventions, discoveries, or ideas, and all patent applications, patents and copyright thereon.

36.2 All Developed Software and all work product and all worldwide Intellectual Property rights in and to the foregoing shall be owned by Motorola.

36.3 Both source code and object code versions of any Developed Software shall be included as deliverables to Motorola.

36.4 The Vendor acknowledges that all deliverables shall be considered "works made for hire", and Motorola will have all right title and interest, including worldwide ownership of all Intellectual Property rights, in and to each deliverable and all copies made from it. If any such deliverable is not considered a work-made for-hire for any reason, the Vendor hereby irrevocably assigns, transfers and conveys, and will cause all Vendor agents and employees to assign, transfer and convey, to Motorola without further consideration all of its and their right, title and interest in and to such Deliverable, including all worldwide Intellectual Property rights in such materials. The Vendor acknowledges that Motorola and the successors and assigns of Motorola will have the right to obtain and hold in their own names any worldwide Intellectual Property rights in and to any such deliverable. The Vendor shall

execute any documents or take any other actions as may reasonably be necessary, or as the Vendor may reasonably request, to perfect Motorola's ownership of any such deliverable. The Vendor hereby waives any and all of its rights under (i) Section 57 of the Indian Copyright Act, as amended ("Copyright Act"), relating to legal, or moral rights that the Vendor may have in any deliverables, and (ii) Section 53 A of the Copyright Act relating to rights that the Vendor may have to in certain resale proceeds of certain of Deliverables that may be deemed to be literary works for purpose of such Section 53A.

37. Ownership of Components supplied by Vendor

37.1 The Vendor, if acceptable to MOTOROLA may reuse all or any of the components developed by it, outside the scope of this contract, for the execution of the projects under this Agreement. The ownership of such components would remain with the Vendor. These components will be identified by the Vendor at the beginning of any project under any Work Order. MOTOROLA and the Vendor would enter a Non-disclosure agreement prior to any discussions pertaining the components being considered for inclusion in any project executed under this agreement."

37.2 Vendor grants to MOTOROLA and its affiliates, a perpetual, irrevocable, worldwide, non-exclusive, royalty free license to Company Background Property necessary to make, have made, use, have used, import, sell, offer for sale, dispose of, distribute and/or create derivative works of Motorola's products embodying the deliverables in whole or part, and to sublicense for the filed of such MOTOROLA products any and all of the foregoing rights to third parties, provided that Company Background Property cannot be used or sub-licensed on a stand alone basis. However, if Motorola wants to use the Company Background Property on a stand alone basis, MOTOROLA will seek Vendor's prior written approval and the parties will agree on the terms and conditions of such use."

17. In the agreement entered into by M/s. Nokia Mobile Phones Ltd., the following are relevant.

"Frame Agreement for Software Development Subcontracting 2.0 dated 21st June, 2001 between Nokia Mobile Phones Ltd. and Sasken Communication Technologies Ltd.

"Deliverable" shall mean all materials, in whatever form, generated or resulting from, the Development, including but not limited to the software program, modules or any part thereof, source code (including comments and procedural code such as job control language and scripts to control compilation and installation) and /or object code, enhancements, applications as well as any other materials, media and documentation which shall be prepared, written and/or developed by the Developer for Nokia under this Agreement and/or Project Order.

"Development" shall mean any development and/or consultancy work as well as other services to be supplied by the Developer, including but not limited to, the development programming, or modification of existing or new software or systems or any part thereof, as well as any services, applications, enhancements, documentation, materials, or other Deliverables as defined herein, which Developer performs or is obliged to perform for Nokia or on behalf of Nokia under a Project Order.

"Development Price" shall mean the aggregate price payable by Nokia to the Developer for the Development and the deliverable provided by the Developer to Nokia a separate Project Order.

3. Scope of supply of the developer.

3.1 The Developer shall perform the Development and provide the deliverables to Nokia in accordance with the term and conditions of this Agreement The content of the Development and the Deliverables shall be set out in the relevant Project Order.

3.2 Except for the items that Nokia agrees to provide in a Project Order, the Developer shall be solely responsible (at no cost to Nokia) to provide any and all hardware software and other tools that may be required, to carry out the Development and provide the deliverables.

3.3 The Developer's project organisation shall be detailed in the Project Order. The Developer shall provide status reports to Nokia in a form and at times reasonably required by Nokia.

3.4 The Developer shall at his expense provide Nokia at a reasonable request detailed reports on the aggregate value of the Development ordered under this Agreement as well as any open questions submitted by the Developer to Nokia, as well as description of such Development ordered and of quotations open.

3.5 The Developer shall upon request by Nokia give Nokia access to all facilities that may reasonably be required to enable Nokia to monitor the progress of the Development and afford Nokia the right to verify at source that a Deliverable conforms to the Specifications and other specified requirements. Any such monitoring or verification shall be without prejudice to any other rights of Nokia under this Agreement or the Project Order and shall not relieve the Developer from any of its obligations under this Agreement or the Project Order nor shall such verification be used by the Developer as evidence of effective control of quality.

3.6 The Developer shall not without the prior written consent of Nokia engage any subcontractor to perform any part of its obligations under this Agreement or the Project Order. However. notwithstanding any such consent from Nokia, the Developer shall remain fully responsible and liable for the performance of any subcontractor. The Developer shall ensure that the agreement with its possible subcontractors shall include the duties and obligations of the Developer under this Agreement

3.7 Notwithstanding any degree of instructions given by Nokia to or project management, exercised over the Developer's personnel assigned to perform a Development or other tasks under a Project Order, such personnel shall at all times be deemed to be the employees of the Developer and under no circumstances shall relationship of employer and employee be deemed to arise between Nokia and the Developer's personnel.

The Developer warrants that such personnel are subject to the supervision of the Developer, notwithstanding the obligation of such personnel to comply with any regulations or requirements of Nokia.

3.8 The Developer is responsible for fulfilment of any and all obligations and tasks as an employer that are provided for by any applicable laws or regulations. This includes but it is not restricted to liability to fulfil and take care of all work permit issues, company and individual tax liabilities as well as social security and pension contributions. The Developer's employees shall be properly insured in accordance with any applicable laws and regulations. Nokia shall in no way be responsible for insuring the employees of the Developer.

The Developer shall upon request of Nokia provide Nokia at any time during the term of this Agreement with proof of fulfilment of above mentioned employer's obligations."

18. The assessing authority after going through the contracts entered into by the assessee with the customers *viz*., M/s Alcatel Lucent Technologies, M/s Motorola, M/s Texas Instruments and M/s Nokia, has held as under: -

"1. There is a requirement from the companies for deliverables both in terms of hardware and software or either of the hardware or software.

2. In majority of the cases, the technocrats go to the place of business of the client companies of M/s Sasken and carry out project work. The project work is defined in the work order/ purchase order, the deliverables so developed by M/s Sasken is in accordance with the requirement of the client companies. The description of the deliverables will he as per the work order and following this agreement. In fact, purchase order is based on master agreement based on which work orders are issued. Work order specifies the deliverables. So, it is considered that Master agreement itself construes the nature of transaction and proposals of tax shall be on the strength of the said master agreement.

3. Though the nomenclature of the work carried out is mentioned as services, the scope of work and other classes of the agreement confirms that there is a development of software and normally it is carried out on software of the client company resulting in development of altogether new software.

4. The Master agreement also speaks of the deliverables incorporating the development. So it is admitted that there is a development of code on your part and it should, he handed over to the clients concerned. This amounts to sale of intangible goods in view of judgment by the Hon'ble Supreme Court in the case of *M/s TCS* v. *State of Andhra Pradesh*. The transfer of intellectual property from the technicians of M/s Sasken to the client parties will constitute sale of goods in terms of the judgment.

5. In respect, of ownership of the products (deliverables), every other agreement specifies that any software developed, reports, designs, programs, specifications, documentations etc., created by Sasken along with any pre-existing IP. reports will be the property of the Clients. This will amount to sales exigible to tax under the KVAT Act, 2003.

The company is an embedded communications solution provider with telecom value chain and accelerates product development life cycles. In a nut shell, activities of the company have been specified in this sentence. It is a solution provider in the meaning assigned by the software companies. It accelerates product development life cycles, connotes nothing else but development of software. The company profile obtained by the Senior Manager, narrates as under:

Sasken offers a unique combination of research and development consultancy, wireless software products and software services, and works with Network OEMs, Semiconductor Vendors, Terminal Device OEMs and Operators across the world. Global fortune 500 and Tier 1 companies in these segments are part of Sasken's customer profile,

Sasken offers a suite of outsourcing service offerings - new product development, test services, porting services and sustenance and support-for Data Network Equipment vendors and Management Software Vendors.

Committed to innovation, Sasken works with customers to held them get to market ahead of the competition, and stay focused on new product development and manufacturing. With deep understanding of the communications industry, access to current and emerging technologies, mature development processes, global resources and a proven track record, Sasken creates complete solution to help clients succeed. Clients choose Sasken for the comprehensive range of application solution and services backed by a proven reputation for expert support and high quality."

19. From the aforesaid reasons of the assessing authority, it is clear that the assessee is in the business of creating complete solutions to his clients. They have a comprehensive range of applications, services and solutions. They are a solution providers. They are in the development of software. Their solutions and services are backed by a proven reputation for expert support and high quality. The assessee provides solutions and develops software and the same is carried out on the software of the client company. The said software developed has to be on a media and then handed over to the customer. The transfer of property from the technicians of the assessee to the client constitute sale of goods in terms of the judgment and therefore liable to sales tax. It is the correctness of the said reasoning and finding which is assailed in these proceedings.

20. The terms of the contract set out above make it clear that the contract is one for rendering service. The assessee is paying service tax levied on the said service rendered, under the provisions of the Act, which is enacted by the Parliament by virtue of the power conferred on it under Article 248 of the Constitution which reads as under:-

"248. *Residuary powers of legislation.*—(1) Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent list or State List.

(2) Such power shall include the power of making any law imposing a tax not mentioned in either of those Lists."

"Entry 97 in List-I reads as under:—Any other matter not enumerated in this List-II or List-III including any tax not mentioned in either of those Lists."

21. Article 246(1) of the Constitution specifies that the Parliament has exclusive, powers to make laws with respect to any of the matters enumerated in List 1 in the Seventh Schedule of the Constitution. As per Article 246(3), the State Government has exclusive powers to make laws with respect to matters enumerated in List II (State List). In respect of the matters enumerated in List III (Concurrent List) both Parliament and State Government have powers to make laws. The service tax is made by Parliament under the above residuary powers. Once the Parliament has made a law dealing with this aspect of service by virtue of the residuary power conferred on them by the Constitution. Article 248 comes into operation. It declares

that Parliament has exclusive power to make any law with respect to any matter not enumerated in Concurrent List of the State Laws. Such power shall include the power to make laws, imposing tax not mentioned in either of these lists. Therefore, in fact once the Parliament makes a law, it excludes the other Legislatures to make a law in respect of which the Parliament has made law.

22. Article 254 deals with the inconsistency between the laws made by Parliament and laws made by the Legislatures of the States which reads as under:-

"(1) If any provision of a law made by the Legislature of a State is repugnant to any provision of a law made by the Parliament which Parliament is competent: to enact, or to any provision of an existing law with respect to one of the matters enumerated in the Concurrent List, then, subject to the provisions of Clause(2), the law made by the Parliament whether passed before or after the law made by the Legislature of such State, or. as the case may be, the existing law shall prevail and the law made by the Legislature shall, to the extent of the repugnancy to be void.

(2) Where a law made by the Legislature of a State with respect to one of the matters enumerated in the Concurrent list contains any provision repugnant to the provisions of an earlier law made by Parliament or an existing law with respect to that matter, then, the law so mode by the Legislature of such State shall, if it has been reserved for the consideration of the President and has received his assent prevail in that State:

Provided that nothing in this clause shall prevent Parliament from enacting at any time any law with respect to the same matter including a law adding to amending, varying or repealing the law so made by the Legislature of the State."

The first part deals with the laws made by the Parliament and the State Legislature in the field of legislation which is clearly ear marked for them namely, List-I and List-II. The second part deals with the law made in respect of the Entries in the concurrent list over which both the Parliament, and Legislature has power. In List-II. there is no Entry providing for making of a law and imposition on Information Technology and software.

23. However, the Act was amended by inserting Section 65(105) (*zzzze*) which came into effect from 16-5-2008 which provides for service in relation to Information Technology software for using in the course, or furtherance of business or commerce including

(*i*) development of Information Technology software.

(*ii*) study, analysis, design and programming of information technology software,

(*iii*) adaptation, up-gradation, enhancement, implementation and other similar services related to information technology software.

(*iv*) 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 start-up phase of a new system, specifications to secure a database, advice on proprietary information technology software

(*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*) providing the right to use information technology software supplied electronically.

24. Admittedly, the entries regarding service does not find a place either in List-II or List-III. The Parliament, has the competence to pass a legislation in respect of the same including imposing of tax. It is in furtherance of such a power conferred under Article 248 read with Entry 97 of List-1 the said service has been inserted in the Finance Act, 1994.

25. The Karnataka Value Added Tax Act, 2003 is enacted by the State Legislature by virtue of Entry No. 54 in List II of Schedule VII which reads as under: -

"54. Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92A of List I."

26. The word "goods" is defined under the Constitution of India at Article 366(12) as under:

"Goods includes all materials, commodities, and articles."

27. In the Karnataka Value Added Tax Act, 2003, Section 2 (15) defines the term "Goods" as under:-

"Goods" means all kinds of movable property (other than newspaper, actionable claims, stocks and shares and securities) and includes livestock, all materials, commodities and articles (including goods, as goods or in some other form) involved in the execution of a works contract or those goods to be used in the fitting out, improvement or repair of movable property, and all growing crops, grass or things attached to, or forming part of the land which are agreed to be severed before sale or under the contract of sale;"

28. However, in the VI Schedule to the Karnataka Value Added Tax, 2003, under the heading of works contract "the programming and providing of computer software" is included. The VI Schedule came into effect by Act 4 of 2006 with effect from 1-4-2006. It reads as under;

Sixth Schedule

[Section 4(1)(c)]

Sl. No.	Description of works Contract	Rate of Tax
**	**	**
11	Programming and providing of computer software	Four per cent

In Schedule VI to the said Act with effect from 1.4.2006 tax is sought to be levied on sale or purchase of goods involved in works contract. One such works contract which is specified in VI Schedule is programming and providing of computer software. Therefore, if the works contract of programming and providing of computer software involves apart from agreement

of service, the agreement to sell the goods the State Legislature can levy tax on such goods. It is after the introduction of VI Schedule on 1.4.2006, the Act was amended by inserting Section 65 (105) (*zzze*) with effect from 16.5.2008 providing for service in relation to information technology software for using in the course of furtherance of business or commerce including development of Information Technology software, study, analysis, design and programming of information technology software. Information and technology software includes computer software. In other words programming and providing of computer software prescribed in VI Schedule now forms part of Section 65(105) (*zzze*). However, it is well settled that there is no prohibition in law to impose a tax both by the Parliament and the State Legislature on different aspects. In other words, on the aspect of service. Parliament can levy tax and on the aspect of sale of goods, the State Legislature has the power to levy tax.

29. The Apex Court in the case of *Imagic Creative (P.) Ltd.* v. *CCT* [2008] 12 STT 392 held as under : -

"28. We have, however, a different problem at hand. The appellant admittedly is a service provider. When it provides for service, it is assessable to a tax known as service tax. Such tax is leviable by reason of a parliamentary statute. In the matter of interpretation of a taxing statute, as also other statutes where the applicability of Article 246 of the Constitution of India, read with the Seventh Schedule thereof is in question, the Court may have to take recourse to various theories including "aspect theory" as was noticed by this Court in *Federation of Hotel & Restaurant Assn. of India* v. *Union of India.* [1989] 3 SCC 634.

29. If the submission of Mr. Hegde is accepted in its entirety, whereas on the one hand, the Central Government would be deprived of obtaining any tax whatsoever under the Finance Act, 1994, it is possible to arrive at a conclusion that no tax at all would be payable as the tax has been held to be an indivisible one. A distinction must be borne in mind between an indivisible contract and a composite contract If in a contract, an element to provide service is contained, the purport and object for which the Constitution has to be amended and Clause (29-A) had to be inserted in Article 366, must be kept in mind.

30. We have noticed hereinbefore that a legal fiction is created by reason of the said provision. Such a legal fiction, as is well known, should be applied only to the extent for which it was enacted. It, although must be given its full effect but the same would not mean that it should be applied beyond a point which was not contemplated by the Legislature or which would lead to an anomaly or absurdity.

31. The Court, while interpreting a statute, must bear in mind that the Legislature was supposed to know law and the legislation enacted is a reasonable one. The Court must also bear in mind that where the application of a parliamentary and a legislative Act comes up for consideration; endeavours shall be made to see that provisions of both the Acts are made applicable.

32. Payments of service tax as also VAT are mutually exclusive. Therefore, they should be held to be applicable having regard to the respective parameters of service tax and the sales tax as envisaged. in a composite contract as contradistinguished from an indivisible contract. It may consist of different elements providing for attracting different nature of levy….."

30. Wherever legislative powers are distributed between the Union and the States, situations may arise where the two legislative fields might apparently overlap. It is the duty of the Courts, however difficult it may be, to ascertain to what degree and to what extent, the authority can deal with matters falling within these classes of subjects exists in each Legislature and to define, in the particular case, before them, the limits of the respective powers. It could not have been the intention that a conflict should exist; and, in order to prevent such a result the two provisions must be read together, and the language of one interpreted, and where necessary modified by that of the other. From time to time that legislation, though purporting to deal with a subject in one list, touches also on a subject in another list, and the different provisions of the enactment may be so closely intertwined that blind observance to a strictly verbal interpretation would result in a large number of statutes being declared invalid because the Legislature enacting them may appear to have legislated in a forbidden sphere. In such circumstances the true nature and character is to be ascertained for the purpose of determining whether it is legislation with respect to matters in this list or in that list. It is popularly known as 'pith and substance'. The law 'with respect to, a subject might incidentally 'affect' another subject in some way; but that is not the same thing as the law being on the latter subject. There might be overlapping; but the overlapping must be in law. The same transaction may involve two or more taxable events in its different aspects. But the fact that there is an overlapping does not detract from the distinctiveness of the aspects. The true nature and character of the legislation must be determined with reference to a question of the power of the Legislature. The consequences and effect of the legislation are not the same thing as the legislative subject-matter. What matters is the nature and character of the legislation and not its ultimate economic results that matters.

31. Therefore, if computer programming and providing of computer software involves two aspects, one falling within the power of the Parliament and the other falling within the power of the State Legislature to enact the law, the law so enacted cannot be found fault with. When the programming and providing of computer software is treated as works contract, as the works contract necessarily involves an agreement to render service and an agreement for sale of goods, service aspect could be taxed by the Parliament and the sale of goods aspect could be taxed by the State Legislature. But, this distinctiveness of two transactions is to be ascertainable from the terms of the composite contract. If such an intention is not discemable from the terms of the contract then we have to find out what is the pith and substance of the contract or in other words what is the true nature and character of the contract. If on an examination of the contract as a whole, it is not possible to discern that the contract involves sale of goods but is essentially an agreement to render service, neither the concept of a works contract nor the concept of aspect theory is attracted. It is by virtue of Entry 54 in List II of the VII Schedule the Karnataka Value Added Tax is enacted by the State Legislature, as the State Legislature is competent to enact laws in respect of sale of goods. By introducing a schedule to the said enactment and describing under a works contract "programming and providing a computer software is specified", unless the said works contract involves an element of sale of goods, the State Legislature has no power to levy tax under the said Act. Similarly, the Parliament also has no power to levy service tax on sale of goods if by including in the Finance Act, development of information technology software, study, analysis, design and programming, information technology software and various other aspects touching software if it involves sale of goods. It has to be necessarily confined to the service aspect. In both the enactments they specify the types of activities which are liable for tax. A duty is cast on the Court to interpret those provisions in such a harmonious way so as to uphold the right of both the legislations to levy tax which fall within their respective sphere.

Deemed Sale

32. The 46th amendment to the Constitution carved out exceptions to the law declared by the Supreme Court and introduced the concept of 'deemed sale' to enable the States to levy tax on the sale aspect. The 46th amendment to the Constitution which introduced clause (29-A) to Article 366 specifically provided for those types of cases where, in respect of the very same transaction, both the State Legislature as well as the Parliament can make law. Sub-clause (b) of clause (29-A) of Article 366 specifically deals with works contract. It reads thus:

"366. Definitions

"(29A) Tax on the sale or purchase of goods includes—

(*a*) ** ** **

(*b*) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;"

33. In a works contract, splitting of service and supply of goods has been constitutionally permitted by introducing the concept of deemed sale. Therefore, the works contract in truth, represents two distinct and separate contracts which are discernable as such. Then the State would have the power to separate the agreement to sell from the agreement to render service, and impose a tax on sale. Therefore, the works contract is necessarily a composite contract, consisting of both an agreement to sell goods and an agreement to render service. No one can deny the legislative competence of the States to levy sales tax on sales provided that the necessary concomitants of a sale are present in the transaction and the sale is distinctly discernable in the transaction. This does not however allow the State to entrench upon the union list and tax services by including the cost of such service in the value of the goods.

34. Therefore the legislative intention is that the expression of 'sale of goods' In Entry 54 should bear precise and definite meaning it has in law, and that the meaning should not be left to fluctuate with the definition of sale, in a law relating to sale of goods, which might be in force for the time being. If the words "sale of goods" has to be interpreted in their legal sense, that sense can only be what it has in the law relating to sale of goods. The ratio of the rule of interpretation that words of legal import occurring in a statute should be construed in their legal sense is that those words have, in law, acquired a definite and precise sense, and that, accordingly, the Legislature must be taken to have intended that, they should be understood in that sense. Therefore while interpreting an expression used in a legal sense, we have only to ascertain the precise connotation which it possess in law. In India, to constitute a transaction of sale there should be an agreement, express or implied, relating to goods to be conveyed by passing on title in those goods. It is the essence of this concept that both the agreement and the sale should relate to the same subject-matter. Where the goods delivered under the contract are not the goods contracted for, the purchaser has a right to reject them, or to accept them and claim damages for breach of condition. Therefore, in law, there cannot be an agreement relating to one kind of property and sale of different property. On the other hand there must be a definite agreement between the parties for the sale of the very 'goods' in which eventually property passes. To sum up, the expression "sale of goods" in Entry 54 is a *nomen juris*, its essential ingredients being an agreement to sell movables for a price and property passing therein pursuant to that agreement.

35. The essential test, to be satisfied before an article is said to be 'goods' is the test of marketability. In the market, the said goods is to be known as a commodity which is useful to a customer. In other words it should be known to the market as goods. That is, such goods must be bought and sold in the market. Therefore, an article or commodity or a material must be something which can ordinarily come to the market to be bought and sold. It must have a distinctive name, character or use. Thereafter it should satisfy the test of abstraction transmission, transfer, delivery, storage and possession, etc.

36. The Forty-sixth Amendment does not give a licence, for example, to assume that a transaction is a sale and then to look around for what could be the goods. The word "goods" has not been altered by the Forty-sixth Amendment. That ingredient of a sale continues to have the same definition. By introducing separate categories of "deemed sales", the meaning of the word "goods" was not altered. Transactions which are mutant, sales are limited to the clauses of Article 366(29-A) Apart from cases falling under sub-clause (b) and (f) of clause (29-A) of Article 366 there is no other service which has been permitted to be so split. If there is an instrument of contract which may be composite in form in any case other than the exceptions in Article 366(29-A), unless the transaction in truth represents two distinct and separate contracts and is discernible as such, the State does not have the power to separate the 'agreement to sell' from the 'agreement to render service', and impose tax on the sale. The question is did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale even if the contract could be disintegrated. The test for deciding whether a contract falls into one category or the other is as to what is the substance of the contract. The seller and such purchaser would have to be *ad idem* as to the subject-matter of sale or purchase. In arriving at a conclusion the court would have to approach the matter from the point of view of a reasonable person of average intelligence.

37. The Apex Court in the case of *Bharat Sanchar Nigam Ltd*. v. *Union of India* [2006] 3 STT 245 dealing with deemed sale has stated as under:

"43. All the clauses of article 366(29A) serve to bring transactions where one or more of the essential ingredients of a sale as defined in the Sale of Goods Act, 1930 are absent, within the ambit of purchases and sales for the purposes of levy of sales tax. To this extent only is the principle enunciated in Gannon Dunkerly Limited. The amendment especially allows specific composite contracts, *viz*., works contracts [(clause(b)), hire purchase contracts (clause(c)), catering contracts (clause(f)) by legal fiction to be divisible contracts where the sale element could be isolated and be subjected to sales tax where the sale element could be isolated and be subjected to sales tax.

44. Gannon Dunkerley survived the 46th Constitutional Amendment in two respects. First with regard to the definition of "sale" for the purposes of the Constitution in general and for the purposes of entry 54 of List II in particular except to the extent that the clauses in Article 366 (29A) operate. By introducing separate categories of "deemed sales", the meaning of the word "goods" was not altered. Thus the definitions of the composite elements of a sale such as intention of the parties, goods delivery, etc., would, continue to be defined according to known legal, connotations. This does not mean that the content of the concepts remain static. Courts must move with the times. But the 46th Amendment, does not give a licence for example to assume that a transaction is a sale and then to look around for what could be the goods. The word "goods" has not been altered by the 46th Amendment. That ingredient of a sale continues to have the same definition. The second respect in which Gannon Dunkerley

has survived is with reference to the dominant nature test, to be applied to a composite transaction not covered by Article 366(29A). Transactions which are mutant sales are limited to the clauses of Article 366(29A). All other transactions would have to qualify as sales within the meaning of the Sales of Goods Act, 1930 for the purpose of levy of sales tax.

45. Of all the different kinds of composite transactions the drafters of the 46th Amendment chose three specific situations, a works contract, a hire-purchase contract and a catering contract to bring within the fiction of a deemed sale. Of these three, the first and third involve a kind of service and sale at the same time. Apart from these two cases where splitting of the service and supply has been constitutionally permitted in clauses (b) and (f) of clause (29A) of Article 366, there is no other service which has been permitted to be so split. For example the clauses of Article 366(29A) do not cover hospital services. Therefore, if during the treatment of a patient in a hospital, he or she is given a pill can the sales tax authorities tax the transaction as a sale? Doctors, lawyers and other professionals render service in the course of which can it be said that there is a sale of goods when a doctor writes out and hands over a prescription or a lawyer drafts a document, and delivers it to his/her client? Strictly speaking with the payment of fees, consideration does pass from the patient or client to the doctor or lawyer for the documents in both cases.

46. The reason why these services do not involve a sale for the purposes of entry 54 of List II is, as we see it for reasons ultimately attributable to the principles enunciated in *Gannon Dunkerley's* case (1958) 9 STC 353 (SC), namely, if there is an instrument of contract which may be composite in form in any case other than the exceptions in Article 366(29A), unless the transaction in truth represents two distinct and separate contracts and is discernible as such, then the State would not have the power to separate the agreement to sell from the agreement to render service, and impose tax on the sale. The test therefore for composite contracts oilier than, those mentioned in Article 366(29A) continues to be - did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale even if the contract could be disintegrated. The test for deciding whether a contract falls into one category or the other is as to what is "the substance of the contract". We will for the want of a better phrase, call this the dominant nature test.

** ** **

50. We agree, after the 46th Amendment the sale elements of those contracts which are covered by the six sub-clauses of clause (29A) of Article 366 are separable and may be subjected to sale tax by the States under entry 54 of List II and there is no question of the dominant nature test applying.

51. What are the "goods" in a sales transaction, therefore, remains primarily a matter of contract and intention. The seller and such purchaser would have to be *ad idem* as to the subject matter of sale or purchase. The court would have to arrive at the conclusion as to what the parties had intended when they entered into a particular transaction of sale, as being the subject-matter of sale or purchase. In arriving at a conclusion the court would have to approach the matter from the point of view of a reasonable person of average intelligence.

Lastly, they held that no one denies the legislative competence of States to levy sales tax on sales provided that the necessary concomitants of a sale are present in the transaction and the sale is distinctly discernible in the transaction.

** ** **

88. This does not however allow State to entrench upon the Union List, and tax services by including the cost of such service in the value of the goods. Even in those composite contracts which are by legal fiction deemed to be divisible under Article 366(29A), the value of the goods involved, in the execution of the whole transaction cannot be assessed to sales tax. As was said in *Larsen & Toubro* v. *Union of India* [1993] 1 SCC 365.

'The cost of establishment of the contractor which is relatable to supply of labour and services cannot be included in the value of the goods involved in the execution of a contract and the cost of establishment which is relatable to supply of material involved in the execution of the works contract only can be included in the value of the goods.'"

38. The test for deciding whether a contract falls into one category or the other is as to what is "the substance of the contract" *i.e.,* the dominant nature of the contract. The test therefore for composite contracts other than those mentioned in Article 366(29A) continues to be, did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale even if the contract could be disintegrated. In order to attract sales tax, it should fall within one of the exceptions provided under the aforesaid provision. If the contract entered into is not a works contract, then that would not fall under any of those exceptions or under the above provision. Therefore, it is necessary to look into the terms of the contract carefully to ascertain the true intent and nature of the contract, what is the nature of activity, what the parties intended, what is agreed upon and what is the consideration paid.

Nature of Contract

39. From the aforesaid Clauses; it is abundantly clear that the parties have entered into an agreement whereby the assessee renders service to the client for development of software, *i.e.,* for software development and other services. Pursuant to the agreement and the work orders, the service shall be performed by the assessee. Services must be requested by issue of a valid work order together with a statement of work. As compensation for the service rendered to the customer, the fees specified in the relevant work order or in the statement of work is payable and billing is done on a time and material basis or on a fixed price on a monthly basis. Pricing for time and material projects shall be fixed at a rate setforth in Annexure-A to the agreement.

40. The assessee agrees, that all patentable and unpatentable, inventions, discoveries and ideas which are made or conceived as a direct or indirect result of the programming or other services performed under the agreement shall be considered as works made for hire and shall remain exclusive property of the client and the assessee shall have no ownership interest therein. Promptly; upon conception of such an invention, discovery, or idea the assessee agrees to disclose the same to the client and the client shall have full power and authority to file and prosecute patent applications thereon and maintain patents thereon. At the request of the client, the assessee agrees to execute the documents including but not limited to copyright assignment documents, take all rightful oaths and to perform such acts as may be deemed necessary or advisable to confirm on the client all right, title and interest in and to such inventions, discoveries or ideas, and all patent applications, patents, and copyrights thereon. Both the source code of developed software and hardware projects of worldwide Intellectual Property in and each shall be owned by the client. The assessee acknowledges that all deliverables shall be considered as works made for hire and the client will have all right, title

including worldwide ownership of Intellectual Property Rights in and each deliverable and all copies made from it. If acceptable to the client, the client may reuse all or any of the components developed by the assessee outside the scope of the those contracts for the execution of the projects under this agreement.

41. Therefore, even before rendering service, the assessee has given up his rights to the software to be developed by the assessee. The considerations under the agreement is not for the cost of the project, the consideration is for the service rendered, based on time or man hours. Once the project is developed, all rights in respect of the said project including the Intellectual Property rights vest with the customer and he is at liberty to deal with it in any manner he likes. The assessee has agreed to execute all such documents which are required for the exercise of such absolute rights over the software developed by the assessee.

42. The 'deliverables' has been defined under the agreement to mean all materials in whatever form generated, treated or resulting from the development including but not related to the software modules or any part thereof, the source code and or object code, enhancement applications as well as any other materials media and documentation which shall be prepared, written and or developed by the developer for the client under this agreement and/or Project Order. If the customer agrees to provide any hardware, software and other deliverables that may be required to carry out the development and provide the deliverables he may do so. Otherwise the assessee has to make or provide all those hardware and software to develop the deliverables and the final product. No doubt at the end of the day, this software which is developed is embedded on the material object and only then the customer can make use of the same. The software so developed even before it is embedded on the material object or after it is embedded on a material object exclusively belongs to the customer. In the entire contract there is nothing to indicate that the assessee after developing the software has to embed the same on a material object and then deliver the same to the customer so as to have title to the project which is developed. The title to the project/software to be developed lies with the customer even before the assessee starts rendering service.

43. In the agreement or from any other material on record, there is nothing to indicate that the assessee purchases the software from the market, improves the same according to the specification of the client and then delivers the same to the client. On the contrary, the agreement clearly discloses that the assessee's technicians either work at their office or go to the place of the client, carry out the project work and find solutions and if at the end of the day, any software emerges, same is embedded on a CD. The software so developed, from the inception is the property of the customer. At no point of time the said software is the property of the assessee. Even before the software/goods came into existence, it was the property of the customer. The terms of the contract as set out above, do not indicate sale of any software. On the contrary, those terms make it very clear that the agreement is a simple service contract, whereunder the assessee provided its staff and its employees who are well trained in the field and who would develop the software according to the specification of the customer.

44. In fact, a careful reading of the agreement shows that, the employees of the assessee and the employees of the customer have to work hand in hand, consult at every stage, have interactions and understand the need and requirement of the customer and through their employees, the software is to be developed. The technicians of the assessee and the employees of the customer are working together at the project site. In most of the cases, the service rendered by the assessee is in the nature of making one of the inputs into a final product which is produced at the project place with the assistance of the staff of service

providers. In fact, the material on record discloses that the customers have engaged the services of several service providers, who have expertise in different fields and all of them put their mind and hands together and find a solution to the problem of the customer. The end product, *i.e.,* the ultimate software, is not necessarily the work of any one such service provider. It is a collective effort. Nobody can claim that the end product exclusively belongs to them except the customer who has paid for the service rendered by the various service providers.

45. As clear from the terms of the agreement, on the day they entered into agreement, there was no software in existence. In other words, there was no goods in existence. The agreement is not for transfer of software. The agreement is for development of software. Even before the software comes into existence, the assessee has given up all the rights and claims of the software to be developed and has expressly agreed that such a software which may come into existence in the end of the contract period is the absolute property of the customer. The customer is at liberty to deal with that software in the manner he wants without further reference to the assessee. The consideration paid is not for transfer of any goods. The consideration paid is calculated in terms of time such as man days, man hours and man months. As on the dale of entering into the contract, both the parties are not clear how much time the contract would ultimately take and when the end product, *i.e.,* the software is produced.

46. Intellectual property comprises of all those things which emanate from the exercise of the human brain, such as ideas, inventions, poems, designs, etc. The word 'property' comes from the Latin word *proprius*, which means "ones own". Intellectual property means, the legal rights which may be asserted in respect of a product of human intellect. The fruits of intellect, would exist even if they enjoyed no legal protection.

47. Intellect is not property by itself. Through intellect, you can create intellectual property. It is that intellectual property that will become "goods" once put on a medium for sale. Intellectual property does not exist in the mind of the technician. What exists in his mind is the intellect. Using that intellect, a technician creates or develops "goods". It is that goods which is called intellectual property when put on a medium for sale. Therefore when a technician creates or develops an intellectual property, there is no element of transfer involved. When such intellectual property is put on a medium for sale, it is capable of being transferred. If transfer takes place, then, it constitutes sale of goods.

48. When a customer gives a software related problem to the technician, to find a solution, if the assessee has a ready made answer, in the form of a ready made software, such software is goods. It may be branded or unbranded software. All that the assessee has to do, is to transfer the goods. Then it amounts to sale of goods. On the contrary, if the assessee has no ready made answer, he has to find an answer by using his intellect or of his employees and has to work on the problem using his intellect. That process is called development or creativity. In the end when he finds a solution to the problem, it means, he has created or developed a software. That software is the intellectual property and will become goods if put on a medium for sale.

49. The easiest way to protect intellectual property is to keep it in one's head. If a person possesses in his head a good idea, there is no risk that any one will see or find it, and thereby appropriate it. Such intellectual property may be preserved thus until its owner chooses to divulge it. If the idea consists of a process of doing some thing, it even remains securely in

the possession of its owner if he performs that process when no one sees him performing. The possessor of such property can take it to the grave with him, safe in the knowledge that no one will inherit it. There is relatively little potential for the commercial exploitation of intellectual property while it remains in his head. This is because the keeping of an idea to oneself and the commercial utilisation of that idea are inherently contradictory notions. The acquirer of an intellectual property right can derive no financial benefit from it except by using it commercially. He will gain advantage only by making a product and selling it or by charging others who wish to exploit his intellect. When he offers his services or intellect to an employer, he is not selling any intellectual property as none exists on the date of contract of employment. The employer gets a right to exploit the intellect, according to his needs and requirements and he pays for the services rendered. He is not purchasing any intellectual property for the purpose of exploiting the same, as none exists on the date of contract of employment. When an employer hires technicians and pays them salary, a relationship of employer and employee comes into existence. The employer may utilise the services of the technicians for his personal use. He may also lend their services to others, who are in need of them. He may also employ them in the job he has undertaken to execute. In all these cases the technicians are rendering their service by applying their intellect. They are paid for the services rendered. In consideration of the remuneration received they are not selling any intellectual property to any one. They are not in the business of sale of intellectual property. Similarly their employer is also not in the business of sale of any intellectual property. On the other hand they are in the business of rendering service to develop intellectual property or software. Therefore, there is no element of sale involved at any stage of the transaction. The intellectual property developed by the technician in the course of employment and the intellectual property developed in the course of executing service contract does not belong to the technician or the employer. From the inception of the contract, it is the property exclusively belonging to the customer. It is in the nature of an unbranded software. It is client specific. It may be of no use to others. It is not bought and sold in the market. It has no distinctive name or character. It is not known as a commodity in the market. The terms of the agreement between the parties give no indication of a sale or purchase of this software. On the contrary in the entire agreement what is agreed upon is providing the service.

50. In the light of the aforesaid discussion, the finding recorded by the assessing authority that the contract in question involves a sale of software development by the assessee cannot be sustained. It is contrary to the material on record, the constitutional provisions and the law declared by the Apex Court. Accordingly it is hereby set aside.

Alternative Remedy

51. It was contended that against the order passed by the assessing authority, a statutory first appeal and against that appeal, a statutory second appeal is provided and therefore the learned Single Judge was justified in directing the parties to approach the appellate forum and this court should not entertain these appeals. Normally, when the statute provides an alternative remedy by way of an appeal, this court declines to entertain a writ petition against such assessment orders. But it is not an invariable rule specifically when the case involves interpretations of constitutional provisions and when the authorities have already interpreted these provisions in a particular manner, the question of the party approaching the very departmental authorities would make no difference. That apart, these assessment orders are passed after coming into force of the Finance Act, 1994 and when service tax was imposed. The question for consideration is, when once by a parliamentary legislation, service tax is levied on the entire consideration received by the assessee, whether it is open to the State

Legislature to levy sales tax on any portion of the said consideration which has already suffered service tax. Even otherwise also, the question for consideration is as discussed above, whether the contract in question is an indivisible contract or a composite contract and even if it is a composite contract, what is the dominant nature of the contract. These are matters which require to be interpreted by this court. It will have an effect not only on the assessee before this court, but to all the assessees who are similarly placed in the State, so that the law is settled and assessment orders to be passed by the authorities would be in accordance with law. Therefore we do not see any merit in the contention that merely because an alternative remedy is provided against these orders by way of statutory appeals, that this court should not entertain these writ appeals. Hence, we pass the following order :

(*a*) Writ appeals are allowed.

(*b*) The contracts in question are not works contract but contract for service simplicitor. In other words it is not a composite contract, consisting of contract of service and contract of sale of goods. It is an indivisible contract of service only.

(*c*) The impugned order passed by the learned Single Judge and the assessment orders passed by the authorities levying sates tax are hereby set aside.

(*d*) The tax paid by the assessee in pursuance of the interim order passed in the writ petitions is ordered to be refunded to the assessee as it is declared that the assessee is not liable to pay any sales tax at all on the consideration received under the contract.

(*e*) The amount shall be refunded with interest @ 6% within four months from the date of receipt of this order. If the amount is not refunded within four months, the said amount shall carry interest @ 12%.

(*f*) No costs.