CCE V. ACER: TAXATION OF SOFTWARE GOES BOINK![1]

Alok

I. INTRODUCTION

Taxation of software generally is a tricky area, especially in India given legislative lethargy and the cutting edge nature of the technology. The present paradigm of Indian indirect taxation is still reflective of a 19th century model which sees an economy in terms only the manufacture of goods[2], or the rendering of service. It does not take into account the importance of knowledge management (better known as IPR) as an aspect of wealth creation in a modern economy which India strives to be, and which we are constantly assured, is right around the corner.[3] Although "canned software" is technically taxable under the Central Excise Act, 1994 read with the Central Excise Tariff Act, 1985,[4] nevertheless important concepts that are inherently linked to Excise duty, such as "manufacture"[5], "goods"[6] and valuation[7] have not been suitably modified by the legislature.[8] In this context, judicial pronouncement would be an important part of the "filling in" the gaps in the legislative framework.

Unfortunately, some judicial pronouncements in this area, as exemplified by the instance of Supreme Court in Central *Commissioner of Excise v. Acer Computers*[9], have only contributed to the confusion surrounding the matter. In this case comment, I shall show how the Honourable Judges of the Supreme Court not only erred in the law applicable, but also erred in the manner in which the law was to be applied, apart from completely ignoring their own dicta in previous cases. Yet, the Court somehow manages to arrive at the right conclusion despite these mistakes, though that is small consolation for a tax practitioner (or worse, law student) who wishes to make sense of this judgment.

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1. With due apologies to Bill Waterson, creator of *Calvin and Hobbes*, author of *Scientific Progress Goes Boink*!
2. See generally Central Excise Act, 1994 [hereinafter CEA].
3. For the definition and importance of a "knowledge economy", see Peter Drucker, *The Age of Discontinuity: Guidelines to Our changing Society* (1969).
4. See Chapter 85, heading 24 of the Central Excise Tariff Act [hereinafter CETA]. Although exigible to excise duty, rate applicable to software is 0%.
5. Section 2(d) of the CEA.
6. Section 2(f) of the CEA.
7. Section 4 of the CEA.
8. For the exigibility of canned software to sales tax, see *TCS v. State of Andhra Pradesh,* AIR 2005 SC 371 (separate concurring opinion of Sinha J)
9. 2004(8) SCALE 169 (hereinafter "ACER")

Despite the flaws in the reasoning of this judgment, it has nonetheless been cited as authority in the case *Tata Consultancy Service v. State of Andhra Pradesh*[10], for the proposition that software is exigible to taxation.[11] The aim of this case comment is to outline the deficiencies in judgment, and point out the flaws in the manner in which the conclusion has been arrived at.

II. FACTS AND JUDGEMENT IN CCE V. ACER

A. FACTS OF THE CASE

The question in *ACER* is essentially one of valuation. Here the respondent, a manufacturer of "computers, peripherals, servers, note books[sic] and accessories"[12] was asked by the Revenue to pay excise duty on the assembled computers sold by them, with the value of the operating system loaded on to such systems being included in the value of the computers.[13] The respondent contended that the value of the operating system need not be added to that of the computer since the operating system did not in anyway add to the value of the computer sold or make the computer "saleable".[14]

Before the High Court, the Revenue's contention was rejected on the basis of the decision of the Supreme Court in *PSI Data Systems Ltd. v. Collector of Central Excise*[15]. In appeal before the Supreme Court, the matter was brought before a Division Bench where the correctness of *PSI Data Systems* was challenged on the ground that a computer cannot run without an OS, and therefore the Court erred in ignoring the value of the OS for the purposes of Excise Duty. The matter was therefore placed before a Larger Bench comprising of N. Santosh Hegde, S.B. Sinha and Tarun Chatterjee JJ.

B. JUDGMENT AND RATIO OF THE SUPREME COURT

Apart from upholding the decision in *PSI Data Systems*[16], the Court found in favour of the respondent, with reasoning that I have broken down into the following salient points.

1. Computers and Computer software are different classes of goods for the purposes of Central Excise.

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10. AIR 2005 SC 371.
11. See Ibid., ¶. 49.
12. *ACER ¶.* 2
13. Ibid ¶ 2-4
14. Ibid ¶ 8
15. MANU/SC/0181/1997 hereinafter *PSI Data Systems.*
16. ACER ¶ 84.

2. Since they are classified differently, the value of one cannot be added to the value of the other for the purposes of Excise Duty even if bundled together.
3. The definition of "transaction value", under section 4(3)(d) must be subject to the charging section, i.e. section 3.
4. As software is not exigible to tax itself, it cannot be made part of the transaction value of the computer on which it is loaded.
5. The Revenue cannot levy tax on software where it has been exempted under the statute.[17]

It is my submission that proposition 1 is completely irrelevant, propositions 2 and 3 are plainly wrong in law, and propositions 4 and 5, being conclusions based on propositions 2 and 3 are also incorrect. Broadly, I would like to address my criticism of this case on two fronts:

a. The dispute relates to valuation and not classification as the Court has made it out to be.
b. Section 3 and Section 4 are completely independent provisions, and the latter is not subject to the former as the Court seems to suggest.

III. TWO WRONGS THAT (ACCIDENTALLY) MAKE A RIGHT: CRITICISM OF THE REASONING IN ACER

A. CONFUSING VALUATION AND CLASSIFICATION

For the taxation of any goods exigible to excise duty under the CEA, it is first seen whether such goods are exigible to tax, then the goods to be taxed are valued in accordance with the CEA or the Valuation Rules under the CEA, and the rate as found in the CETA is then imposed on the value, to finally compute the tax payable.[18] The principles of classification and valuation are two separate parts of the matter, and must not be confused.[19] This simple, elementary principle of taxation has been turned on its head by the Court, which begins by trying to determine the rate at which computers and computer software are being taxed, and then proceeds to determine value.

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17. See ACER ¶.84.
18. See section 3 of the CEA.
19. *See Andhra Pradesh Paper Mills Ltd. v. CCE*, 1993 (65) E.L.T. 447; *Col-Tubes (P.) Ltd. V. CCE*, 1994 (72) ELT 342; *Steel Tractors v. CCE*, 1995 (75) ELT 897 (Tri-Del); *CCE v. Eicher Tractors*, 2001 (127) ELT 846 (CEGAT). On the specific aspect of taxation of software *Tata Unisys Ltd. V. CCE*, 1994 (73) ELT 96 (Tri-Del). The last case has not been considered by the Court at all though the reasoning of the Tribunal would apply en force to this particular case. Also see, *Union of India and Ors. etc. v. Bombay India International Ltd.*, AIR 1984 SC 420 where the Supreme Court has held that the measure of levy did not conclusively determine the nature of levy.

To some extent, the fault could be laid at the doorstep of the respondent's counsel as well. Whereas the Revenue argued that the software should be included in the *value* of the PC to be taxed, it was contended by the respondent, that the software could not be included in the value because it was classified separately from the hardware in the CETA and therefore, could not be taxed along with the hardware itself.[20]

The Revenue's argument, in my opinion could have been adequately met by pointing out that hardware was capable of being sold without the software itself, and no real "value" was being added by the software apart from the value of the software itself. In other words, the hardware did not become marketable simply by the installation of the related software, and the software added on was only a marketing practice to attract more consumers.[21]

The Court also goes into a long and tortuous discussion on the aspect of classification that only complicates the matter and raises more questions that are unanswered.[22] The Court keeps questioning exigibility of software to excise duty, raising questions such as whether computer programmes are "goods" and whether the process by which they are produced is "manufacture" for the purposes of the Act, when clearly these aspects are irrelevant to the matter at hand.[23] According to the Court, since software has been exempt[sic] from excise duty, the Revenue would not be justified in imposing the same on software that has been installed on a computer's hard drive.[24] Intuitively this seems correct, but this was an unwarranted and pointless deviation that raises more questions, which even more curiously, the Court completely dodges. The Court brushes aside this problem simply by stating:

"We, however, place on record that we have not applied our mind as regard the larger question as to whether the informations [sic] contained in a software would be tangible personal property or not or whether preparation of such software would amount to manufacture under different statutes".[25]

Moreover, in its "Conclusion", the Court does not, at any point, refer even once to the contention on valuation that was raised by the Revenue and totally fails to rebut the argument made by the Revenue in this regard.[26]

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20. ACER ¶¶ 9-16.
21. For the test of marketing see *Union of India v. Delhi Cloth Mills,* AIR 1963 SC and subsequent case law that have followed the same.
22. See ACER ¶¶ 54-68.
23. For a discussion on the definition of "goods" and "manufacture" see *DCM* supra, n.20. Excise will be imposed on an 'excisable good' only if it has been manufactured. See *CCE v. Indian Aluminium Co Ltd.,* 2006 (203) ELT 3 (SC).
24. ACER ¶¶ 84.
25. ACER ¶85.
26. ACER ¶. 83-86

The Court's ratio seems to be that since software is taxed at 0% rate, it is exempt and consequently, should not be indirectly taxed[27] by including its value in the taxable value of the computer. However, if computer software was taxed at say, 8%, then the question arises as to what rate should the software loaded on computer hardware (taxed at 12%) be taxed? This is another one of those tricky questions that ought to have been answered, but conveniently ignored by the Court. In fact, as the Supreme Court itself has held, the mere exemption of a particular good from duty will not mean that the levy of excise duty on the good itself has been removed.[28]

It must be restated here that the matter in question did not revolve around whether software itself was exigible to excise duty, but whether the value of software installed on computer hardware could be added to the value of the computer hardware for the purposes of imposing duty on the computer hardware. Whereas these questions need to be answered when a case concerns the imposition of excise duty on software alone, they are irrelevant to a discussion on valuation that involves computer software. By going off on this tangent, the Court has unnecessarily complicated a fairly straightforward case, which could have been decided by applying the correct principles.

B. INCORRECT INTERPRETATION OF SECTIONS 3 AND 4.

Section 3 of the CEA is the charging section prescribing the levy of duty on excisable goods, whereas section 4 deals with how such the value of the goods on which the duty is payable has to be determined, whether through transaction value or other means prescribed in the Rules[29].

The Court states that Section 4 is subject to Section 3.The basis for doing so is entirely flimsy. The Court argues, with little authority to fall back on, that Section 4 is in fact subject to Section 3, which is the charging section of the Central Excise Act.[30] The Court would be justified in drawing such a conclusion if Section 4 opened with the words, "Subject to.." or if section 3 contained a non-obstante clause.[31] However, these being two separate and distinct provisions of law, each operating in its own field[32] the Court's assumption that Section 4 is subject to Section 3 is somewhat dubious.

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27. Pun intended!
28. *Hico Products Ltd. v. Collector of Central Excise*, 1994 (71) E.L.T. 339 (SC).
29. See Central Excise Valuation (Determination of Price of Goods Rules), 2000.
30. ACER ¶¶ 54-56, 84.
31. See Vepa P Sarathi, *Interpretation of Statutes*, 578-582 (2005, Fourth Edition) and cases cited therein for a discussion on the scope and interpretation of the non-obstante clause.
32. See *Proctor and Gamble Hygiene & Health Care ltd. V. CCE*, 2005 (190) ELT 289 (SC), where the Supreme Court pointed out the difference between "valuation", found in section 4 as it stood then, and "excisability" as found in section 3 as the provisions stood stood then.

This conclusion is further rocked when one examines that the definition of "transaction value", as contained in section 4(3)(d):

3) for the purposes of this section, -

(d) "transaction value" means the price actually paid or payable for the goods, when sold, and includes in addition to the amount charged as price, any amount that the buyer is liable to pay to, or on behalf of, the assessee, by reason of, or in connection with the sale, whether payable at the time of the sale or at any other time, including, but not limited to, any amount charged for, or to make provision for, *advertising or publicity, marketing and selling organization expenses, storage, outward handling, servicing, warranty, commission or any other matter*; but does not include the amount of duty of excise, sales tax and other taxes, if any, actually paid or actually payable on such goods." [emphasis mine]

Clearly, it contains elements that cannot be said to be "excisable goods" for the purposes of section 3. The Court's interpretation of Sections 3 and 4 is thus fatally flawed as it does not give a harmonious interpretation[33] of the provisions contained in the legislation.

By holding that the hardware and the software loaded onto such hardware are classified differently for the purposes of the CETA, the Court held that the value of the latter cannot be added to the former. The Court also misinterpreted the scope of sections 3 and 4 subjecting the latter to the former without any textual basis for such an interpretation. Using this line of reasoning, the Court holds that the value of the software may not be added to the value of the computer while determining the exigibilty to tax.

However, it is evident that section 4 stands independent of section 3, and valuation of excisable goods is made on the basis of section 4 alone. The correct test to determine whether value of software has to be included in value of the computer would be the test of marketability. In the present context, the software loaded on to the computer did not by itself make the computer marketable.

IV. CONCLUSION

While one does not doubt the ultimate conclusion drawn by the Court in this context[34], nonetheless, the manner in which the Court has proceeded to decide the matter is highly inadequate, and raises more questions than it answers. What is

33. See *Sanjeevayya v. Election Tribunal,* AIR 1967 SC 1211.

34. In the limited fact situation that the Court has restricted itself to, i.e., where the customers are given the option of choosing the operating systems on their desktop PCs, the value of the Operating Systems so chosen will not be added to the value of the PCs in calculating the assessable value of the goods.

even more disturbing is that the Court actually recognizes the questions its line of reasoning has raised, i.e., the definition of "goods" encompassing software for the purposes of Central Excise and the process of producing software amounting to "manufacture". These questions should not have arisen in this case, and even if the Court did raise them, it should have at least sought to answer them coherently and completely on the basis of the existing law.

As mentioned above, the Court should have applied the test of marketability, i.e., determine whether the software itself made the hardware marketable, and then gone on to decide how the software should have been valued if it was. Though the same conclusion would have been arrived at, it would have made for a clearer understanding of the law in this aspect.

It is therefore submitted that the conclusions in this case need re-examining in light of the errors pointed out earlier. It must be also pointed out that Tribunals, with a couple of exceptions[35], have been wary of applying the "ratio" of this case, taking care to examine the basis on which the decision was arrived at.[36] The hesitation in applying the principles laid down in this case is perhaps an indication of the doubts the Tribunals have with regard to the findings of this case. While the Supreme Court itself has been somewhat reluctant to adhere strictly to the finding in this case[37], no doubt in light of the inadequacies earlier-mentioned, it is necessary for the Court to come out and closely re-examine this decision at the earliest, clearing up the law on this vital matter for the benefit of the industry and the Revenue itself.

35. See *Bhayanagar Metals Limited v. CCE*, 2007 (116) ECC 170 where the CESTAT, in ¶.7 cites *ACER* and the CESTAT decision of *Commissioner of Customs, Mumbai v. Hewlett Packard* MANU/CM/0049/2006 (overturned in the above Supreme Court case) approvingly without a full examination of what each case held. *See also, Aluplex India Pvt. Ltd. V. CCE*, MANU/CM/0665/2006. As mentioned earlier, *ACER* also finds mention in *TCS v. State of AP,* supra note 10.
36. *See e.g., D.J. Malpani v. CCE*, 2005 (191) ELT 516 (Tri-Mumbai); *Adani Exports v. CCE,* MANU/CB/7169/2006;
37. *See CC, Chennai v. Hewlett Packard India Sales (p) Ltd.*, 2007 (215) ELT 484 (SC) where the Court rejected the application of the *ACER* case to a similar fact situation involving laptops on the ground that Laptops are different from Desktop PCs in that the former came loaded with the operating system and was integral to the functioning of the laptop. It must be noted that this was a customs case as against the *ACER* which is an excise case. *See also, Anjaleem Enterprises Pvt. Ltd. V. CCE, Ahmedabad,* 2006 (194) ELT 129 (SC) where the Supreme Court rejected the application of the principle of *ACER* once again on the ground of difference in facts.