

# Sales Tax and Cloud Computing in India

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## Abstract

This Article, the first of its kind, addresses the question of imposition of sales tax on Cloud computing transactions in India. Several industry estimates show that the Cloud computing market is growing in India and is poised to grow further. However, the question of how to tax these transactions remains to be addressed. This Article engages with this question, albeit only in the context of sales tax. The Indian Constitution lays down, in elaborate detail, the taxes that can exclusively be levied by the Union Parliament and those that can exclusively be levied by the State Legislatures. Sales tax on intra-state transactions of a sale, a local sales tax, can be levied exclusively by State Legislatures. Keeping in mind the elaborate constitutional arrangement, the history of the levy of sales tax on software sale transactions in India and the well-established jurisprudence of the Supreme Court of India on the point, this Article argues that local sales tax on Cloud computing transactions cannot be levied by the State Legislatures. The Indian Constitution allows the State Legislatures to levy sales tax on certain transactions by a deeming fiction of law. In other words, certain transactions can be deemed to be a 'sale' even if they truly are not. Relying on the well-established interpretation of those constitutional provisions by the Supreme Court of India, this Article argues that such deeming fictions of law provided for in the Indian Constitution cannot be extended to Cloud computing transactions.

Article 366(29A) of the Indian Constitution provides that certain transactions, even if they are not 'sales' may be deemed to be 'sale' in order for the State Legislatures to levy local sales tax. This Article anticipates that if the State Legislatures attempt to levy local sales tax on Cloud Computing transactions, recourse would necessarily be had to Article 366(29A). But if the Supreme Court's well-established jurisprudence on the point is to be considered, the Court has never allowed the State Legislatures to take liberty with the words of Article 366(29A). This Article attempts to demonstrate that the text of the deeming fiction provisions in Article 366(29A), as consistently interpreted by the Supreme Court, would not allow the State Legislatures the constitutional competence to deem a Cloud computing transaction as a sale

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in order to levy local sales tax on such transactions. The Article also flags the point that the text of Article 366(29A), if interpreted in its true context, is not capable of bearing an interpretation that would allow a Cloud computing transaction to be deemed a sale.

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## Introduction

Cloud computing is expected to be the next big thing in the Information Technology (IT) industry in India. It is expected to be a “game changer” for the approximately 50 million startups and small businesses there.<sup>1</sup> So what is Cloud computing? It is “essentially a network of remote servers” that enables its users to “store, manage[,] and process data and use programs through a web-based interface.”<sup>2</sup> Data and program stored in the Cloud can be accessed from anywhere.<sup>3</sup> Cloud computing is essentially a process by which data storage capacity and software use can be rented, to be accessed through a computer, but without actually storing the data or installing the software

<sup>1</sup>Neeraj Pawha Jetley, *Cloud computing in India is set to explode*, CNBC, May 11, 2014, <http://www.cnbc.com/id/101626286>.

<sup>2</sup>*Id.*

<sup>3</sup>*Id.*

on the computer.<sup>4</sup> It is a new “computing model in which users purchase IT resources as a service, allowing them to take a pay-as-you-go approach.”<sup>5</sup> The Cloud has been analogized to a utility—water supply or electricity supply—where “users can access IT resources at any time and from multiple locations, track their usage levels, and scale up their IT capacity as needed without large upfront investments in software or hardware.”<sup>6</sup> Cloud computing, popularly referred to as simply the “Cloud,” is a new method of using IT resources in which several computers and servers are linked together that the user can access through the Internet from anywhere in the world.<sup>7</sup> In other words, if you are a professional (or even an amateur) photographer and like to use Photoshop to touch up your work, you need not install the software on your computer. You also need not save all your work on your computer. You can subscribe to the services of a Cloud computing solution, which would allow you to store all your data on the Cloud server and use Photoshop on the Cloud server as well (for a fee). But you are forever free from the chance that your computer might crash one day and you would lose all your data. Cloud computing thus provides “flexibility, scalability[,] and cost-effectiveness,” which are stated to be some of the key reasons why many businesses are adopting this new technology.<sup>8</sup>

In an interview given to McKinsey, Sanjay Kapoor, CEO (India and South Asia) at the Indian IT giant Bharti Airtel Ltd., expressed his views on the future of Cloud computing in India.<sup>9</sup> In Kapoor’s experience:

Everyone I talk to believes that data consumption will increase by some astronomical figure but when I ask them how their IT spend [*sic*] is going to grow, many talk of either capping their IT expenses or even lowering them. That tells me that the only way to manage these IT expenses is by taking the

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<sup>4</sup>Harichandan Arakali, *For IT giants, cloud computing delivers what it promises*, FORBES INDIA, Aug. 6, 2014, <http://forbesindia.com/article/boardroom/for-it-giants-cloud-computing-delivers-what-it-promises/38345/1>.

<sup>5</sup>Kreg Nicholas & Kara Sprague, *Getting ahead in the cloud*, MCKINSEY & COMPANY, Autumn 2011, [http://www.mckinsey.com/-/media/mckinsey/dotcom/client\\_service/public%20sector/pdfs/mck%20on%20govt/it%20challenge%20and%20opportunity/mog7\\_cloud.ashx](http://www.mckinsey.com/-/media/mckinsey/dotcom/client_service/public%20sector/pdfs/mck%20on%20govt/it%20challenge%20and%20opportunity/mog7_cloud.ashx).

<sup>6</sup>Nicholas & Sprague, *supra* note 5, at 50.

<sup>7</sup>Orly Mazur, *Taxing the Cloud*, 103 CALIF. L. REV. 1, 2 (forthcoming 2015).

<sup>8</sup>*Roadmap to the Cloud*, MONEYCONTROL, Oct. 19, 2014, <http://www.moneycontrol.com/accelerateindia/article.php?autono=120550>; Manzur, *supra* note 7, at 3.

<sup>9</sup>Andre Levisse & Gautam Kumra, *Digitally united: An interview with Sanjay Kapoor, CEO, Bharti Airtel Ltd., India and South Asia*, MCKINSEY & COMPANY, Apr. 2012, [http://www.mckinsey.com/-/media/mckinsey/dotcom/client\\_service/telecoms/pdfs/recall\\_no17\\_interview.ashx](http://www.mckinsey.com/-/media/mckinsey/dotcom/client_service/telecoms/pdfs/recall_no17_interview.ashx).

products and services to the cloud.<sup>10</sup> The cloud seems to be inevitable, and I believe it will drive productivity.<sup>11</sup>

Kapoor noted that the adoption of Cloud computing will not be limited to large corporations, but, rather, there will be “countless small and medium-sized businesses and home offices where I think the real impact will be seen.”<sup>12</sup>

A study conducted by a US based private market intelligence firm International Data Corporation (IDC) estimates that the Cloud market in India “stood at \$688 million in 2012.”<sup>13</sup> This figure is “expected to rise to \$3.5 billion by 2016.”<sup>14</sup> Another study by another US based technology research and advisory company Gartner estimates the total size of the market for “[C]loud-based services” in India, in 2014, at \$557 million and anticipates it will triple by 2018.<sup>15</sup> IBM is reportedly preparing to build its first Cloud data center in India with a 30,000 square-foot facility coming up in Airoli, on the outskirts of Mumbai, with \$1.2 billion allocated for investment.<sup>16</sup> Microsoft is also reported to be setting up Cloud data centers in India by the end of 2015 in order to capture what its CEO Satya Nadella calls “a \$2 trillion market opportunity.”<sup>17</sup> Indian IT giant Tata Communications has already partnered up with Google to provide Cloud computing solutions to businesses in India.<sup>18</sup> Even the Indian government is reportedly “seeking to deploy Cloud technologies to deliver e-government services.”<sup>19</sup>

Clearly the members of the IT profession and those invested in the IT industry in India and globally are very excited about the Cloud coming to India. Millions of dollars would ultimately be spent on establishing Cloud computing facilities in India, bringing much needed foreign investment to India and creating hundreds of jobs. Experts and industry leaders in India and abroad have anticipated a huge demand for Cloud computing solutions.

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<sup>10</sup> See, e.g., Charles Goulding et al., *The Tax Aspects of Cloud Computing and Data Centers*, 12 CORP. BUS. TAX’N MONTHLY 9, 9 (2010) (observing that, “Cloud Computing is a highly modernized, automated and economical approach that is becoming increasingly popular among leading companies like Apple and Microsoft”).

<sup>11</sup> Levisse & Kumra, *supra* note 9.

<sup>12</sup> Levisse & Kumra, *supra* note 9.

<sup>13</sup> Jetley, *supra* note 1.

<sup>14</sup> Jetley, *supra* note 1.

<sup>15</sup> Arakali, *supra* note 4.

<sup>16</sup> Varun Aggarwal, *IBM’s first cloud data centre in India to focus on private services for SMEs*, THE ECONOMIC TIMES, Oct. 27, 2014, [http://articles.economicstimes.indiatimes.com/2014-10-27/news/55482991\\_1\\_public-cloud-services-market-cloud-providers-cloud-computing;IMB\\_expands\\_cloud\\_push\\_with\\_first\\_India\\_data\\_centre](http://articles.economicstimes.indiatimes.com/2014-10-27/news/55482991_1_public-cloud-services-market-cloud-providers-cloud-computing;IMB_expands_cloud_push_with_first_India_data_centre), CBROnline, Oct. 27, 2014, <http://www.cbronline.com/news/cloud/cloud-saas/ibm-expands-cloud-push-with-first-india-data-centre-271014-4418139>.

<sup>17</sup> *Id.*

<sup>18</sup> *Tata Comm partners Google for cloud computing services*, BUSINESS STANDARD, Nov. 6, 2014, [http://www.business-standard.com/article/pti-stories/tata-comm-partners-google-for-cloud-computing-services-114110601299\\_1.html](http://www.business-standard.com/article/pti-stories/tata-comm-partners-google-for-cloud-computing-services-114110601299_1.html).

<sup>19</sup> Nicholas & Sprague, *supra* note 5, at 51.

It is almost certain that the Cloud computing services would be sold and purchased by big, medium, and small businesses alike in India. Accordingly, it is natural to deduce that several Cloud computing solutions or products, tailored to the needs of the clients, will be offered on the market.

While everyone is very pleased with these new developments—as they should be—not much attention has been given to the possible tax implications that might arise.<sup>20</sup> In other words, how is a Cloud computing transaction to be taxed? Is it a sales transaction—because then the local value added tax laws and the federal Central Sales Tax Act might apply? Is it a service transaction? If it is, then the federal Service Tax laws (*i.e.*, Finance Act, 1994) will apply. Is it a combination of both? If it is, then it needs to be determined what amount of the transaction is to be subjected to local value added taxes, federal Central Sales Tax, Service Tax, or all of the above. Is there an element of royalty payment involved in a Cloud computing transaction? Many questions of this nature will arise. This Article will engage with these questions and attempt to flag possible tax implications that might arise in the future in relation to the Cloud.

In order to engage with these questions, this Article is divided into four parts. Part I deals with the elaborate constitutional arrangement provided for in the Indian Constitution with regards to division of legislative power between the Union Parliament and State Legislatures. The Indian Constitution neatly divides the power to levy various taxes between the Union Parliament and the State Legislatures. This division of power was originally laid down in the Government of India Act, 1935, that was drafted by the British.<sup>21</sup> During the drafting of the Indian Constitution (from 1947 to 1949), the Drafting Committee and the Constituent Assembly accepted the arrangement as laid down in the Government of India Act, 1935.<sup>22</sup> Much of the constitutional litigation before the Supreme Court of India<sup>23</sup> and its predecessor, the

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<sup>20</sup>Not much has been written on the possible tax implications arising out of Cloud computing transactions in India or outside. Some law review articles talk about Cloud computing, but the context is completely different. See, *e.g.*, Malvika Jayaram, *The Business of Privacy: From Private Anxiety to Commercial Sense? A broad Overview of why Privacy Ought to Matter to Indian Businesses*, 4 NUJS. L. REV. 567 (2011). Jayaram's article tackles with the theme of "corporate greed for capturing personal data, coupled with increasing surveillance by governments [making] privacy a critical theme for public discourse."

<sup>21</sup>See GRANVILLE AUSTIN, *THE INDIAN CONSTITUTION: CORNERSTONE OF A NATION*, 194-207 (2011).

<sup>22</sup>See 1 HOMI M. SEERVAI, *CONSTITUTIONAL LAW OF INDIA*, 164 (4th ed. 2014), M. P. JAIN, *INDIAN CONSTITUTIONAL LAW*, 531 (Ruma Pal & Samaraditya Pal eds., 6th ed. 2010).

<sup>23</sup>INDIA CONST. art. 124, § 1 ("There shall be a Supreme Court of India consisting of a Chief Justice of India and, until Parliament by law prescribes a larger number, of not more than seven other judges."). The number of Supreme Court judges has now been increased to 30 by the Supreme Court (Number of Judges) Amendment Act, 2008. As of November 22, 2014, the total number of sitting judges in the Supreme Court of India is 28 (including the Chief Justice of India, Mr. Justice H. L. Dattu).

Federal Court of India,<sup>24</sup> has been in the context of Legislative Competence Review. Part I of this Article describes this elaborate constitutional arrangement whereby legislative authority to levy taxes has been divided between the Union Parliament and the State Legislatures. Part I also flags the relevant constitutional issues that are anticipated to arise in the context of taxation of Cloud Computing transactions. Those constitutional issues are revisited at appropriate places throughout this Article.

Part II of this Article deals with the imposition of excise duty on Cloud computing transactions because “software” is listed in the relevant and applicable excise taxes statutes as an excisable item. Part III of this Article engages with the question of imposition of the sales tax or value added tax by the State Legislatures on Cloud computing transactions. Part IV engages with the complex issue of characterization of a Cloud computing transaction. At the heart of this issue is the key question: What is the most appropriate characterization of a Cloud computing transaction? Is it a transaction of “sale,” whereby “goods” are “sold” to the consumers, or is it a transaction of “service” whereby, certain services are rendered to clients for a fee? What is the most appropriate method of such characterization?

## I. Constitutional Arrangement

In India, both the State Legislatures and the Union Parliament can impose sales tax on sales transactions. A quick review of the relevant provisions of the Indian Constitution would help to understand this concept better. Chapter I of Part XI of the Indian Constitution controls the legislative relations between the Union Parliament and State Legislatures.<sup>25</sup>

Article 245 of the Constitution makes the Union Parliament constitutionally competent to enact laws for the whole or any part of the territory of the Indian Union, while State Legislatures are competent to enact laws for the territory of the State.<sup>26</sup> The laws have to comply with the Fundamental Rights that have been guaranteed under Part III of the Constitution and may be declared void by the Supreme Court of India if they are inconsistent with the fundamental rights.<sup>27</sup> However, a law enacted by the Union Parliament

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<sup>24</sup>Government of India Act, 1935, § 200. The Federal Court of India sat for 12 years (1937 to 1950) until the Supreme Court of India was established by the adoption of the Indian Constitution in 1950. See SUPREME COURT OF INDIA, last accessed Nov. 22, 2014, <http://supremecourtindia.nic.in/history.htm>.

<sup>25</sup>INDIA CONST. arts. 245-55.

<sup>26</sup>*Id.* art. 245, § 1 (“Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.”); see also *id.* art. 1, § 1 (declaring that India is a “Union of States”); *id.* art. 1, § 3 (“territory of India” comprises of the “territories of the States,” the “Union territories” and “such other territories as may be acquired”).

<sup>27</sup>*Id.* art. 13, § 2 (“The State shall not make any law which takes away or abridges the rights conferred by this Part and any law made in contravention of this clause shall, to the extent of the contravention, be void.”).

cannot be declared invalid because it has “extra-territorial” operation.<sup>28</sup> In context of taxation laws, however, a distinction has been drawn between laws having extra-territorial operation and extra-territorial laws.<sup>29</sup> On the basis of this distinction it has been argued that the Union Parliament is not constitutionally competent to enact extra-territorial laws.<sup>30</sup>

Seventh Schedule of the Indian Constitution divides the subjects or fields of legislation into three lists: the “Union List,” “State List,” and “Concurrent List.”<sup>31</sup> The Union Parliament has the exclusive power to legislate on all the subjects enumerated in the Union List.<sup>32</sup> The State Legislatures have the exclusive power to legislate on all subjects mentioned in the State List.<sup>33</sup> Both the Union Parliament and the State Legislatures can legislate on the subjects enumerated in the Concurrent List.<sup>34</sup> The residuary power of legislation (*i.e.*, the power to legislate on a subject not mentioned in any of the three lists) is exclusively reserved for the Parliament.<sup>35</sup> In case of an inconsistency between laws made by the Union Parliament and a State Legislature on a subject falling in the Concurrent List, the Parliamentary law prevails over the State law,<sup>36</sup>

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<sup>28</sup> *Id.* art. 245, § 2 (“No law made by the Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation.”).

<sup>29</sup> Khagesh Gautam, *Taxing offshore transactions in India and the Territoriality Clause—The case for substantial constitutional limitations on Indian Parliament’s power to retrospectively amend the Income Tax Act*, 40 INTERNATIONAL TAX JOURNAL 19 (2014).

<sup>30</sup> Gautam, *supra* note 29, at 29.

<sup>31</sup> INDIA CONST. art. 246, Seventh Schedule.

<sup>32</sup> *Id.* art. 246, § 1 (“Notwithstanding anything in clauses (2) and (3), Parliament has the exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the “Union List”).”).

<sup>33</sup> *Id.* art. 246, § 3 (“Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the “State List”).”).

<sup>34</sup> *Id.* art. 246, § 2 (“Notwithstanding anything contained in clause (3), Parliament and, subject to clause (1), the Legislature of any State also, have the power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the “Concurrent List”).”).

<sup>35</sup> *Id.* art. 248, § 1 (“Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List.”); *see also id.* art. 246, § 2 (“Such power shall include the power of making any law imposing a tax not mentioned in either of those lists.”); Seventh Schedule, List I—Union List, Entry 97 (“Any other matter not enumerated in List II or List III including any tax not mentioned in either of those.”)).

<sup>36</sup> *Id.* art. 254, § 1 (“If any provision of a law made by the Legislature of a State is repugnant to any provision of a law made by 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 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 of the State, shall, to the extent of the repugnancy, be void.”).



unless the State law has been made with assent of the Indian President.<sup>37</sup> India does not have a Presidential form of government though. The Indian system resembles the Westminster Prime Ministerial form of government. Therefore, because of the “Presidential Aid and Advice Clause,”<sup>38</sup> Presidential assent in India for most practical purposes means the assent of the Union Cabinet.<sup>39</sup>

In Indian constitutional jurisprudence, it has been traditionally understood that the constitutional authority of the Union Parliament and the State Legislatures to legislate on the respective subjects enumerated in the three lists mentioned in the Seventh Schedule comes from Article 246 of the Constitution and not from the Seventh Schedule.<sup>40</sup> The Seventh Schedule only lists the subjects (or areas, or fields) of legislation.<sup>41</sup> Within the Seventh Schedule it has also been traditionally understood in India that in order to claim constitutional competence to enact a law imposing a tax it has to be shown that there is an entry in the relevant list that specifically authorizes the imposition of such tax.<sup>42</sup> In other words, for example, entry 42 in the

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<sup>37</sup> *Id.* art. 254, § 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 made 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 the 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.”); *see also id.* art. 52 (“There shall be a President of India”); *id.* art. 53(1) (“The executive power of the Union shall be vested in the President and shall be exercised by him either directly or through officers subordinate to him in accordance with this Constitution.”).

<sup>38</sup> *See* Khagesh Gautam, *When the aid and advice of the Council of Ministers is in conflict with the Presidential oath*, MyLaw.NET, Oct. 8, 2013, <http://blog.mylaw.net/tag/aid-and-advice-clause/>.

<sup>39</sup> INDIA CONST. art. 74, § 1 (“There shall be a Council of Ministers with the Prime Minister at the head to aid and advise the President who shall, in the exercise of his functions, act in accordance with such advice.”).

<sup>40</sup> *See, e.g.,* Welfare Ass’n v. Ranjitt P. Gohil, (2003) 9 S.C.C. 358, 378 (India) (“The fountain source of legislative power exercised by Parliament or the State Legislatures is not Schedule 7; the fountain source is Article 246 and other provisions of the Constitution.”). The opinion in this case was delivered by a Division Bench.

<sup>41</sup> *See, e.g.,* Indian Aluminium Co. v. State of Kerala, (1996) 7 S.C.C. 637, 647 (India) (“Under Article 246(3) of the Constitution, every State legislature has explicit power to make law for that State with respect to the matters enumerated in List II (State List) of the Seventh Schedule to the Constitution . . . . The power is derived under Article 246 . . . . The legislative fields are of enabling character designed to define and delimit the respective areas of legislative competence of the respective legislatures.”). The opinion in this case was delivered by a Division Bench.

<sup>42</sup> *See, e.g.,* All India Fed’n of Tax Practitioners v. Union of India, (2007) 7 S.C.C. 527, 545 (India) [hereinafter Tax Practitioners Case] (The opinion in Tax Practitioners Case was delivered by a Division Bench of the Supreme Court, and was written and delivered by Justice Kapadia, later Chief Justice of India); Southern Pharms. & Chems. v. State of Kerala, (1981) 4 S.C.C. (India) 391; State of Bihar v. Shree Baidyanath Ayurved Bhawan (P) Ltd., (2005) 2 S.C.C. 762, 781 (India).



Union List, “Inter-State trade and commerce,” would not make the Union Parliament constitutionally competent to enact a law imposing a tax on inter-State trade and commerce. It would be entry 92A in the Union List, “Taxes on the sale and purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce,” that would make the Union Parliament constitutionally competent to enact a law levying a tax on an inter-State transaction of sale. Therefore in the event of a taxation law being challenged as unconstitutional for the lack of legislative competence, it must be shown that there is no entry in the corresponding list in the Seventh Schedule authorizing the levy of such a tax. This much is traditionally understood and is beyond dispute.

The Union Parliament is allowed to impose an income tax on income other than agricultural income,<sup>43</sup> which is reserved solely for States.<sup>44</sup> With the exception of agricultural land, it can also impose taxes on the capital value of assets and can also tax the capital of corporations.<sup>45</sup> It can also impose a tax on the sales or purchase of goods provided that such sales or purchase happens in the course of inter-State trade or commerce.<sup>46</sup> And it can also levy taxes on services.<sup>47</sup> The State Legislatures can levy what is known in India as an “entry tax.”<sup>48</sup> The States also impose a sales tax or a value added tax (VAT) on intra-State sales of goods, other than newspapers.<sup>49</sup> States can also impose taxes on goods and passengers carried by road or on inland waterways<sup>50</sup> and on “luxuries”<sup>51</sup> (even though the word “luxuries” is nowhere defined in the Indian Constitution). It should also be noted here that whereas the authority to levy taxes on services is vested with the Union Parliament, the States are

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<sup>43</sup>INDIA CONST. art. 246, Seventh Schedule, List I—Union List, Entry 82 (“Taxes on income other than agricultural income”).

<sup>44</sup>*Id.* art. 246, Seventh Schedule, List II—State List, Entry 46 (“Taxes on agricultural income”).

<sup>45</sup>*Id.* art. 246, Seventh Schedule, List I—Union List, Entry 86 (“Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies”).

<sup>46</sup>*Id.* art. 246, Seventh Schedule List I—Union List, Entry 92A (“Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce”). Entry 92A was inserted in the Union List by the Constitution (Sixth Amendment) Act, 1956.

<sup>47</sup>*Id.* art. 246, Seventh Schedule, List I—Union List, Entry 92C (“Taxes on Services”). Entry 92C was inserted in the Union List by the Constitution (Eighty-Eighth Amendment) Act, 2003.

<sup>48</sup>*Id.* art. 246, Seventh Schedule, List II—State List, Entry 52 (“Taxes on entry of goods into a local area for consumption, use or sale therein”).

<sup>49</sup>*Id.* art. 246, Seventh Schedule, List II—State List, Entry 54 (“Taxes on the sale or purchase of goods other than newspapers, subject to provisions of entry 92A of List I”).

<sup>50</sup>*Id.* art. 246, Seventh Schedule List II—State List, Entry 56 (“Taxes on goods and passengers carried by road or on inland waterways”).

<sup>51</sup>*Id.* art. 246, Seventh Schedule List II—State List, Entry 62 (“Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling”).

authorized to levy taxes on “professions, trades, callings and employment.”<sup>52</sup> Surprisingly, or perhaps thankfully, there are no taxation entries pertinent to the issues being discussed in this Article in the Concurrent List.<sup>53</sup>

The Definitions Clause of the Indian Constitution<sup>54</sup> provides definitions for 30 key terms and phrases. “Goods” is defined in an inclusive manner as, “including all materials, commodities[,] and articles.”<sup>55</sup> However, “materials,” “commodities,” and “articles” are not defined in the Definitions Clause. For the purposes of this Article, Article 366(29A), which was inserted by the 46th Amendment in 1982, is the most material provision because it defines the phrase “tax on the sale or purchase of goods.”<sup>56</sup> Article 366(29A) was inserted into the Constitution by the 46th Amendment after the recommendations of the Law Commission of India as made in its 61st Report in May 1974.<sup>57</sup> The specific history of the 61st Report leading to the 46th Amendment and the consequent issues that arise (relevant for this Article) will be addressed in detail later in this Article.<sup>58</sup> It would be sufficient to note here that Article 366(29A) inserted into the Indian Constitution “deeming fiction” provisions to enable State Legislatures to impose sales tax on certain transactions that were heretofore not exigible to sales tax. These were: (1) transfer of “property

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<sup>52</sup>*Id.* art. 246, Seventh Schedule, List II—State List, Entry 60 (“Taxes on professions, trades, callings and employments”).

<sup>53</sup>The only entry in the Concurrent List regarding taxation is about recovery of taxes due to the state. *See* INDIA CONST. Seventh Schedule, List III—Concurrent List, Entry 43—“Recovery in a State of claims in respect of taxes and other public demands including arrears of land-revenue and sums recoverable as such arrears, arising outside that State.” In addition, the only other entries in the Concurrent List that may fairly be said to be taxation entries are Entry 44 (“Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty”) and Entry 47 (“Fees in respect of any of the matters in this List, but not including fees taken in any court”). In *Shree Digvijay Cement Co. v. Union of India*, (2003) 2 S.C.C. 614 (India), a Division Bench of the Supreme Court held that an essential feature of a tax was ‘a compulsory extraction of money.’ Applying the holding of *Digvijay Cement*, it may fairly be said that a ‘stamp duty’ and a ‘fee’ satisfy the requirement of being a compulsory extraction of money. *See also* Commissioner Hindu Religious Endowments v. Shirur Mutt, A.I.R. 1954 S.C. 282 (India). Speaking for the unanimous Seven judge constitution bench, Justice Mukherjea observed that, “Our Constitution has, for legislative purposes, made a distinction between a tax and a fee and while there are various entries in the legislative lists with regard to various forms of taxes, there is an entry at the end of each one of the three lists as regards fee which could be levied in respect of any of the matters that is included in it. The implication seems to be that fees have special reference to governmental action undertaken in respect to any of these matters.”

<sup>54</sup>INDIA CONST. art. 366 (“Definitions”).

<sup>55</sup>*Id.* art. 366, § 12.

<sup>56</sup>*Id.* art. 366, § 29A (inserted by Constitution (Forty-Sixth) Amendment Act, 1982, § 4).

<sup>57</sup>LAW COMMISSION OF INDIA, SIXTY-FIRST REPORT ON CERTAIN PROBLEMS CONNECTED WITH POWERS OF THE STATES TO LEVY A TAX ON THE SALE OF GOODS AND WITH THE CENTRAL SALES TAX ACT, 1956 at 21, LAW COMMISSION OF INDIA, last accessed Dec. 5, 2014, <http://lawcommissionofindia.nic.in/51-100/report61.pdf> [hereinafter LAW COMMISSION OF INDIA, 61ST REPORT].

<sup>58</sup>*See infra* Part III.A and IV.A.

in any goods” for deferred payment;<sup>59</sup> (2) “execution of a works contract”;<sup>60</sup> (3) a “hire-purchase” transaction;<sup>61</sup> (4) a “transfer of the right to use any goods”;<sup>62</sup> (5) supply of goods by an association to its members;<sup>63</sup> and (6) supply of food or drink for human consumption as a part of a service.<sup>64</sup> These six were deemed to be a sale,<sup>65</sup> even though these could not truly be characterized as a sale.

In the words of the Law Commission of India, because “passing of property” was an essential element of “sale,” the absence of this element could not be compensated by creating a legal fiction in order for a sales tax to be levied.<sup>66</sup> The Law Commission also noted that even at common law the “essence of the transaction” was the passing of property.<sup>67</sup> But then speaking in the specific context of works contract,<sup>68</sup> hire purchase<sup>69</sup> (and transfer of controlled substances<sup>70</sup> the discussion of which is not relevant for this Article), the Law Commission noted that these transactions were in substance transactions of sales.<sup>71</sup> The arrival of this conclusion is highly questionable, but a critique of the Law Commission of India’s 61st Report is beyond the stated brief of this Article. Suffice it to note here that the Law Commission adopted two tests—(1) what the primary purpose of the transaction is, and (2) whether the

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<sup>59</sup>INDIA CONST. art. 366, § 29A, cl. (a) (“a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration . . .”).

<sup>60</sup>*Id.* art. 366, § 29A, cl. (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 . . .”).

<sup>61</sup>*Id.* art. 366, § 29A, cl. (c) (“a tax on the delivery of goods on hire-purchase or any system of payment by installments . . .”).

<sup>62</sup>*Id.* art. 366, § 29A, cl. (d) (“a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration . . .”).

<sup>63</sup>*Id.* art. 366, § 29 A, cl. (e) (“a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration . . .”).

<sup>64</sup>*Id.* art. 366, § 29A, cl. (f) (“a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration . . .”).

<sup>65</sup>*Id.* art. 366, § 29A (“and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods . . .”).

<sup>66</sup>LAW COMMISSION OF INDIA, 61ST REPORT, *supra* note 57, at 9, ¶ 1.5A. Speaking in the context of levy of sales tax by State Governments, the 61st Report noted in its first chapter that, “it is well-established that a transaction lacking transfer of property cannot be taxed as a sale by creating a legal fiction in the shape of a deeming clause which seeks to extend the concept of ‘sale’ (internal citations omitted).”

<sup>67</sup>*Id.* at 9, ¶ 1.4B (“It would appear that at common law also, ‘sale of goods’ had a narrow meaning, and the passing of property—immediately or at an appointed time—was the essence of the transaction.”).

<sup>68</sup>*Id.* at 7, ¶ 1.1, 12 ¶ 1A.1.

<sup>69</sup>*Id.* at 7, ¶ 1.1.

<sup>70</sup>*Id.*

<sup>71</sup>*Id.* at 21, ¶ 1A.22 cont’d.

article supplied itself has a general market.<sup>72</sup> But a closer reading of the Law Commission's 61st Report shows that the creation of the deeming fiction in Article 366(29A) was not a result of the application of these two tests.

The recommendations subsequently accepted by the Parliament that led to the 46th Amendment of the Constitution were based rather on a principle of constitutional construction. This principle was that the words used in the three legislative lists should receive widest possible interpretation.<sup>73</sup> Thus the narrow interpretation given to the word "sale" by the Supreme Court was not correct.<sup>74</sup> This was the "*principal juridical ground* on which [the Law Commission expressed its] preference for the transfer of the power to tax such contracts to the State Legislatures."<sup>75</sup>

Therefore going forward from here one would be well advised to keep in mind the following few caveats. The recommendations of the Law Commission of India's 61st Report were the ones that resulted in the 46th Amendment to the India Constitution that inserted Article 366(29A).<sup>76</sup> Transactions that are not sales, and could not be treated as sales before the 46th Amendment, did not become sales post the 46th Amendment. They were deemed to be sales for the limited purpose of Entry 54 of the State List (*i.e.*, to enable the State Legislatures to impose sales tax on the same).<sup>77</sup> To what extent was this deeming fiction correct and desirable is a valid question but one that this Article is not meant to investigate. But one must always keep in mind that Article 366(29A)(d) whereby, "a transfer of right to use any goods" is deemed to be a sale, is a legal fiction of a very high magnitude and must be understood and interpreted as such.<sup>78</sup> Law Commission of India's 61st Report was written primarily to address very specific questions of imposition of sales tax on works contracts, hire purchase, and consignment transfers (in context of inter-State sales that only the Union Parliament could tax).<sup>79</sup> The recommendations of the 61st Report that became the 46th Amendment must always be understood and interpreted in their original context. Any extension of the constitutional device of Article 366(29A) that contains legal fictions of a very high magnitude to contexts that they were not originally intended to serve is unwarranted. The 61st Report was not an exercise in jurisprudence. It was an attempt to find a constitutional solution to enable the State Legislatures to levy sales tax on certain transactions that the Supreme Court had held were beyond their legislative competence. Law Commission's 61st Report was a

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<sup>72</sup> *Id.* at 19, ¶ 1A.19 ("[O]ne test is whether primarily the transfer of movable article is taken as such, or whether the transfer is only ancillary to another contract. Another test is whether the article supplied as itself a general market.").

<sup>73</sup> *Id.* at 20, ¶ 1A.21 cont'd.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 20, ¶ 1A.21 cont'd (emphasis added).

<sup>76</sup> INDIA CONST. art. 366, §29A.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* §29A(d).

<sup>79</sup> LAW COMMISSION OF INDIA, 61ST REPORT, *supra* note 57.

“marriage of convenience” to the extent that it was a convenient solution to a constitutional problem. This solution was a highly artificial, but contextually limited, expansion of the concept of “sale.” Any attempt to further expand this highly artificial concept of “sale” by expanding Article 366(29A)(d) and reading it independent of its original context would be tantamount to putting the proverbial cart before the horse.

## II. Excise Duty and Cloud Computing Transaction

Before moving forward an important procedural point must be taken note of for the benefit of those unfamiliar with the inner workings of the Supreme Court of India. The Supreme Court of India ordinarily sits in divisions of two judges that under Article 145 of the Constitution is called a “Division Court” but is popularly known as a “Division Bench.”<sup>80</sup> If in the course of the hearing of any matter before a Division Bench it is felt the matter should be put before a larger bench, the matter is referred to the Chief Justice, who, accordingly, constitutes a bigger bench, usually consisting of three judges.<sup>81</sup> But whenever a case involving a substantial question of law as to the interpretation of the Constitution is involved, a bench of five judges, or more if necessary, must necessarily be constituted.<sup>82</sup> Such a bench is popularly called a “Constitution Bench.” The bigger the bench of the Supreme Court that decides the case, the greater the doctrinal value attached it.<sup>83</sup> Wherever an opinion delivered by the Supreme Court of India is discussed in this Article, the number of judges comprising that bench and those concurring and dissenting has been

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<sup>80</sup>INDIA CONST. art. 145, § 2 (“Subject to the provision of clause (3), rules made under this Article may fix the minimum number of Judges who are to sit for any purpose, and may provide for the powers of single Judges and Division Courts.”). Accordingly the Supreme Court Rules, 1966, Order VII, Rule 1 (relevant part) provides “every cause, appeal or matter shall be heard by a Bench consisting of not less than two Judges nominated by the Chief Justice . . . .” The title of Order VII reads “Constitution of Division Courts and Powers of a Single Judge.” There is a list of eight kinds of matters, in Order VII, Rule 1 that a single judge of the Supreme Court can hear and dispose of, an examination of which is not relevant for this article.

<sup>81</sup>Supreme Court Rules, 1966, Order VII, Rule 2 (“Where in the course of the hearing of any cause, appeal or other proceedings, the Bench considers that the matter should be dealt with by a larger Bench, it shall refer the matter to the Chief Justice, who shall thereupon constitute such a bench for the hearing of it.”).

<sup>82</sup>INDIA CONST. art. 145, § 3 (“The minimum number of Judges who are to sit for the purpose of deciding any case involving a substantial question of law as to the interpretation of this Constitution . . . shall be five: Provided that, where the Court hearing an appeal under any of the provisions of this Chapter other than Article 132 consists of less than five Judges and in the course of the hearing the appeal the Court is satisfied that the appeal involves a substantial question of law as to the interpretation of this Constitution the determination of which is necessary for the disposal of the appeal, such Court shall refer the question for opinion to a Court constituted as required by this clause for the purpose of deciding any case involving such a question and shall on receipt of the opinion dispose of the appeal in conformity with such opinion.”).

<sup>83</sup>See A. LAKSHMINATH, PRECEDENT IN INDIAN LAW (2009); JAIN, *supra* note 22, at 303-04.

mentioned. If no judge dissented, after mentioning the number of judges comprising the bench, the bench is referred to as a “unanimous bench.”

A. *PSI Data Systems v. Collector of Central Excise*

A review of reported Supreme Court opinions shows that the first tax case that involved a tax levy on software was *PSI Data Systems Ltd. v. Collector of Central Excise*.<sup>84</sup> The opinion was delivered by a unanimous Division Bench. While calculating the excise duty<sup>85</sup> on computers, which is a tax on manufacturing, payable under the Central Excise Tariff Act, 1985, the value of the software sold with the computer was added to the value of the computer.<sup>86</sup> The question before the Court was whether “the value of software sold with the computer” could be added to the value of the computer for this purpose.<sup>87</sup> The Court was careful to point out that in this case it was dealing with, “tangible software of the nature of discs, floppies and CD ROMs and not the intellectual property, also called software, that is recorded or stored thereon.”<sup>88</sup>

This caveat added by the Court is of extreme significance. The judicial mentioning of this caveat tells us that the Court is aware of the crucial distinction between (1) the software as such and (2) the medium that carries that software. The Court specifically mentions that the intellectual property in the software is distinct from the medium on which the software is being carried on. This Article will examine this caveat closely. This Article will show that this was not the only time this distinction would be highlighted by the Court.

The Central Excise and Gold (Control) Appellate Tribunal (CEGAT) had held that the value of the software could be added to the value of the computer in order to determine the value of the computer for levy of excise duty.<sup>89</sup> This was held on the basis that a computer system without the system’s software was a “mere hardware” and incomplete. It was the system’s software that made the computer “work.” The Tribunal therefore held:

the liability of the computer system had to be determined with reference to the computer system itself and for assessment of the computer system it was immaterial whether the software was a brought-out item. In the assessment of the computer system an individual part lost its independent identity and became a part of the computer system.<sup>90</sup>

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<sup>84</sup> (1997) 2 S.C.C. 78 (India) [hereinafter *PSI Data Systems*].

<sup>85</sup> See INDIA CONST. art. 246, Seventh Schedule, List I—Union List, Entry 84 (“Duties of excise on tobacco and other goods manufactured or produced in India except—(a) alcoholic liquors for human consumption [;](b) opium, Indian hemp, and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.”).

<sup>86</sup> *PSI Data Systems*, (1997) 2 S.C.C. at 79.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* at 80.

<sup>89</sup> *Id.* at 81.

<sup>90</sup> *Id.*

On appeal, the taxpayers challenged this view taken by the CEGAT and made the following two arguments. Firstly, it was argued that the software that they sold along with the computers was not an essential part of the computer, and, secondly, it was argued that, “What a computer was had to be judged in the light of its commercial sense and, in that sense, the software was not understood to be a part of the computer.”<sup>91</sup> The thrust of both these arguments essentially was to separate the software from the hardware (*i.e.*, the computer or the machine) in such a way that software can exist independent of the hardware. If software and hardware are two distinct “goods,” then their being sold together could not be relevant factor in determining the excisable value of one of them. The Department of Revenue (the Revenue) conceded the first half of this.<sup>92</sup> It was the second half that the Revenue was not willing to concede. The Revenue argued that its concession “did not apply to the firm software that was etched into the computer.”<sup>93</sup> The Court rejected this argument and held that,

a computer and its software are distinct and separate is clear, both as a matter of commercial parlance as also upon the material on record. A computer may not be capable of effective functioning unless loaded with software such as discs, floppies and CD ROMs, but that is not to say that these are a part of the computer or to hold that, if they are sold along with the computer, their value must form part of the assessable value of the computer for the purpose of excise duty.<sup>94</sup>

Therefore the value of the software sold along with the computer could not be included in the assessable value of the computer for calculating excise duty.

Having made it clear that the Court is not speaking in context of the intellectual property in the software, the Court made it clear that software, even of the sort without which the computer would not work, could not be said to be part of the computer. Software and hardware (*i.e.*, the computer) therefore are two distinct things.<sup>95</sup> If they are two separate things, they may be sold separately (which in fact was done by the taxpayer in this case). And if they are separately sold (*i.e.*, bundled together), the value of one of the products in the bundle cannot be used to enhance the value of the other product in the bundle in order for excise duty to be imposed on such value.

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<sup>91</sup> *Id.* at 82.

<sup>92</sup> *Id.* (“The learned counsel for the [Revenue] fairly did not dispute that the value of the software that the appellant might sell with their computers, if so ordered by the purchasers thereof, could not be included in the assessable value of the computers.”).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 83.

<sup>95</sup> Another point worth noting here is that the Central Excise Tariff Act, 1985, classified computers and software in separate headings. This legislative distinction, even though mentioned in the opinion, see *id.* at 80-81, has not been directly referred to justify the final holding of the case. It is a fair question to ask as to the extent to which this legislative distinction impressed the bench but that question is beyond the stated brief of this Article.



*PSI Data Systems*, therefore, is the first reported Indian Supreme Court opinion that this author could find where the dualism between the software as such and the medium that carries the software has been recognized. The dualism does not disappear when the software is sold bundled with the computer. In fact it remains very real and clear to the extent that the value of the software cannot be used to enhance the value of the hardware. The dualism also does not disappear when the software is not sold bundled with the computer but is sold preinstalled, except, for tax purposes, the dualism may be ignored. This is a convenient and practical but a necessarily fictionalized solution. The fact that value of the computer may be enhanced by the value of the software if it sold preinstalled does not negate the dualism that the software and the hardware are inherently different things.

But *PSI Data Systems's* convenient solution raises questions for the future: Can software ever be “sold”? What exactly is meant when the phrase “sale of software” is used in common commercial parlance? If the “tangible” nature of the software as carried in a disc or a CD ROM as described is distinct from the “intellectual property” in the software as caveated by the Court in *PSI Data Systems*, then does it not mean that there are two possible meanings that can be given to the phrase “sale of a software”? As this Article will show, the correctness of *PSI Data Systems* will soon be doubted, and, eventually, it will be affirmed by a unanimous bench of three judges of the Court.

#### B. Affirmation of *PSI Data Systems* in the Second Acer India Case

The opinion in *PSI Data Systems* was delivered in 1997. It was followed almost immediately in 1998 by another unanimous Division Bench in *ORG Systems v. Collector of Central Excise*.<sup>96</sup> The question before the Court in *ORG Systems* was identical to *PSI Data Systems*.<sup>97</sup> The Revenue authorities had taken the view that the “value of peripherals and systems software supplied is includible in the value of the computers.”<sup>98</sup> This view was upheld by the CEGAT on the ground that the “supply of specifications and designs was actually on a par with the supply of specific designs of a tailor-made item and hence will constitute manufacture.”<sup>99</sup> Relying on *PSI Data Systems*, and quoting from it extensively,<sup>100</sup> the view taken by CEGAT was reversed.

The correctness of *PSI Data Systems* was questioned in 2001 by a Division Bench in *Tata Consultancy Services v. State of Andhra Pradesh*.<sup>101</sup> But most notably, in the *First TCS Case*, for the first time, the law involved was the

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<sup>96</sup>(1998) 6 S.C.C. 56 (India) [hereinafter *ORG Systems*].

<sup>97</sup>*Id.* at 57 (“The principal issues in controversy are: . . . (b) whether the value of peripheral devices and/or computer systems sold by [the taxpayers] along with computers are includible in the assessable value of the computer . . .”). There were four issues in this case but the other three are not relevant for this discussion.

<sup>98</sup>*Id.*

<sup>99</sup>*Id.* at 57-58.

<sup>100</sup>*Id.* at 58-59.

<sup>101</sup>(2001) 4 S.C.C. 629 (India) [hereinafter *First TCS Case*].

Andhra Pradesh General Sales Tax Act, 1957, which was a State law and not a Union law (like the Central Excise and Tariff Act, 1985).<sup>102</sup> *PSI Data Systems* and its subsequent following in *ORG Systems*—both were in the context of a law dealing with central excise and not a State sales tax legislation. The taxpayers in this case were selling “specialized and exclusively custom-made” software “to cater to the needs of individual clients” and also “standardized” software for “use of certain classes of clients.”<sup>103</sup> The Andhra Pradesh High Court had held the first category will not constitute “goods” for the purpose of the Andhra Pradesh General Sales Tax Act, 1957, but the second category will and on “sale” of those sales tax will have to be paid.<sup>104</sup>

Resisting the application of Andhra Pradesh’s sales tax on the software falling in the second category, the taxpayer made two arguments. The first argument was essentially aimed at recharacterizing the subject of taxation (*i.e.*, the commodity on which tax has been imposed). State sales tax can be imposed on sale of “goods.”<sup>105</sup> If the subject is not “goods,” the sales tax cannot be imposed. Thus it was argued that this software is “intellectual property being the product of thought creativity and intellectual efforts [that] cannot be ‘goods’ for the purpose of the Act.”<sup>106</sup> The second argument was an attempt to recharacterize the transaction. If a transaction whereby software is “sold” is actually not a transaction of “sale” as legally understood, a sales tax cannot be imposed on this transaction. Thus it was argued that, “what is transferred is the right to use the program (which is a set of instructions) and not the tape on which it is stored.”<sup>107</sup> The Article will pause here and note that these two arguments are independent of each other. Also, that both arguments are equally wide in their scope. If the subject of taxation is not “goods” and for a sales tax there must be “goods,” sales tax cannot be imposed on such a transaction by either the Union<sup>108</sup> or the State. Similarly if a transaction involving software is one on which sales tax is levied, and for a sales tax to be levied there must be a “sale,” if the transaction is not a sale a sales tax cannot be levied on it either by the Union or the State.

As the Article will later show, the second argument is based on a legally stronger foundation because it accurately captures what truly happens when a software is “sold” as commonly understood in commerce, the first argument is legally stronger because the legislatures are given a wide leeway under

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<sup>102</sup> *Id.* at 630.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 630-31.

<sup>105</sup> See INDIA CONST. art. 246, Seventh Schedule, List II—State List, Entry 54 (“Taxes on the sale or purchase of *goods* other than newspapers, subject to provisions of entry 92A of List I.” (emphasis added)).

<sup>106</sup> *First TCS Case*, (2001) 4 S.C.C. at 631.

<sup>107</sup> *Id.*

<sup>108</sup> See INDIA CONST. art. 246, Seventh Schedule, List I—Union List, Entry 92A (“Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.”).

the Indian Constitution to create a deeming fiction of law in order to treat, for the purpose of sales tax, a transaction as sales though in reality it is not a sale.<sup>109</sup> Though one should caution oneself and keep in mind that this does not mean no tax can be imposed on transactions like these at all under the existing constitutional and legal regime.

Opposing the taxpayers position, the Revenue also made a forceful argument. The Revenue essentially argued that, notwithstanding the fact that the software may be transferred using any means other than a disc, the fact that it was indeed transferred using a disc in that instance is the key factor.<sup>110</sup> A very forceful analogy was drawn with film, videotapes, and audiotapes<sup>111</sup> and an opinion delivered by the Supreme Court of Alabama was cited to support the proposition.<sup>112</sup>

The Revenue's arguments raised question on the correctness of *PSI Data Systems*, and the Division Bench was in doubt as to whether *PSI Data Systems* was correctly decided.<sup>113</sup> The Court's doubt on the correctness of *PSI Data Systems* is manifest if we sample the following observation:

[T]he true object of software development contract is not to obtain the service of the consultant, but to obtain software programs consisting of intangible intellectual property which is not taxable. The services used to customize and develop the computer software are part of the final software package and not separate computer and data processing services subject to tax.<sup>114</sup>

This observation is liable to criticism, and would be subject to the same on the appropriate occasion in this Article. Nevertheless, being in doubt as to the correctness of *PSI Data Systems*, the matter was referred to a larger bench.<sup>115</sup> This reference resulted in the assembly of a five-judge Constitution Bench.

While the reference to the larger bench was pending, in 2004, the correctness of *PSI Data Systems* was once again questioned by another Division Bench, and this time in its original context (*i.e.*, law of central excise) in *Commissioner of Central Excise v. Acer India*.<sup>116</sup> The reason was the same. In the words of the Court:

<sup>109</sup> See *infra* Part III.A and Part IV.A.

<sup>110</sup> *First TCS Case*, (2001) 4 S.C.C. at 631 ("While on behalf of the respondents the case of the appellants is resisted on the ground that the magnetic tapes, discs, are necessary to carry the program and for the transfer to the hardware and, therefore, the value of the tapes is equal to the value of the program, that the fact that the program can be transmitted through some other means does not actually take away from the fact that in fact a tangible means was actually used . . .").

<sup>111</sup> *Id.* at 632.

<sup>112</sup> *Id.* (citing *Wal-Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala. 2006)).

<sup>113</sup> *First TCS Case*, (2001) 4 S.C.C. at 631.

<sup>114</sup> *Id.* at 632-33.

<sup>115</sup> *Id.* at 633.

<sup>116</sup> (2004) 10 S.C.C. 111, 112 (India) [hereinafter *First Acer India Case*].

any amount which a buyer has to pay “by reason of or in connection with the sale” is part of the transaction value. There are softwares without which a computer cannot work at all. There may be softwares which contain additional or ancillary applications which a customer may want to buy separately. An additional or ancillary application, would, of course, be classifiable separately and cannot be included in the value of a computer. But a buyer has to buy software without which the computer cannot work. The computer would otherwise be a dead box . . . . *When one talks of a computer, as understood in the trade, it is not just the box or the hardware. A computer contains both hardware and the operating software. The price of such softwares is thus the amount which a buyer is bound to pay by reason of or in connection with the sale of the computers. It appears to us that the price of such softwares is thus includable in the value for purposes of excise duty.*<sup>117</sup>

The matter was accordingly ordered to be referred to a larger bench.<sup>118</sup> Consequently a three-judge bench was constituted to examine the correctness of *PSI Data Systems* and answer the allied questions raised by the *First Acer India Case* that delivered its opinion in the *Second Acer India Case*.<sup>119</sup>

In the *Second Acer India Case*, in the context of the law of central excise, the taxpayers took the same position that they had been taking all along, that the software specifically ordered by the customers would retain their individual character and thus not be exigible to excise taxes.<sup>120</sup> And unlike *PSI Data Systems*, where this point was mentioned by the Court, but no reliance seems to be placed on it, this time it was specifically argued by the taxpayers that under the applicable statute, “hardware and software [were] classified differently under different headings.”<sup>121</sup> Like *PSI Data Systems*, the dualism between the software and the hardware was accepted in principle by

<sup>117</sup> *Id.* at 112-13 (emphasis added).

<sup>118</sup> *Id.* at 113.

<sup>119</sup> Commissioner of Cent. Excise v. Acer India Ltd., (2004) 8 S.C.C. 173, 178 (India) [hereinafter *Second Acer India Case*].

<sup>120</sup> *Id.* at 180 (Justice Sinha for the Court: “[Taxpayers] would submit that . . . the operational software which are implanted on specific orders placed by the customers would retain the characteristics of software and would not lose their identity only because the information contained therein together with the right to use the same is implanted in the computer itself. A computer may have different systems . . . containing parallel or sequential process which would make a computer system complete and the same should not be confused with a mere hardware.”).

<sup>121</sup> *Id.* at 180-81 (Justice Sinha for the Court: “The learned counsel would argue that the hardwares and softwares are classified differently under different headings, viz., Headings 84.71 and 85.24 of the Central Excise Tariff Act. Whereas in respect of the computers the rate of duty is 16%, for softwares is the same is nil and, thus, the assessee was entitled to claim deduction of the value thereof from the total value of the computer. *It was argued that as both the hardware and the software are assessed separately, keeping in view Chapter Note 6 of Chapter 85, which contains a legal text, the valuation of a computer and software cannot be clubbed together for the purpose of assessment of excise duty.*” (emphasis added)).

the Court.<sup>122</sup> And like *PSI Data Systems*, the Court was also conscious of the industry practice of adding the value of entrenched software into the value of the computer for calculating excise duty.<sup>123</sup> The central premise on which *PSI Data Systems* was decided was affirmed by the *Second Acer India Case* bench.<sup>124</sup> *PSI Data Systems* was accordingly affirmed by the unanimous three-judge bench in the *Second Acer India Case*.<sup>125</sup> In the context of Cloud computing transactions though, the single most important observation in the *Second Acer India Case* was that “[a] license to use the information contained in a software can be given irrespective of the fact as to whether it is loaded in the computer or not.”<sup>126</sup> The question as to the true nature of software (*i.e.*, whether it is

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<sup>122</sup>*Id.* at 183, 188-89 (Justice Sinha for the Court: “A customer may place a specific order upon the manufactures of computers for supply of CDs which contain operating softwares like Windows 2000, Windows XP, etc. as also the right to use the same under licence. The said softwares indisputably can be purchased separately and loaded into the computer by the purchasers themselves . . . . It is not in dispute that operational softwares are available in the market separately. They are separate marketable commodities.”); *see also PSI Data Systems*, (1997) 2 S.C.C. at 80 (Justice Bharucha for the Court: “We make it clear at the outset that when we shall speak of software, we shall be referring to tangible software of the nature of discs, floppies and CD ROMs and not to the intellectual property, also called software, that is recorded or stored thereon.”).

<sup>123</sup>*Second Acer India Case*, (2004) 8 S.C.C. at 183 (Justice Sinha for the Court: “As is the general practice in the computer industry, the value of firmware etched on the EEPROM is always included in the assessable value of the computer.”); *see also PSI Data Systems*, (1997) 2 S.C.C. at 79-80 (Justice Bharucha for the Court: “It is not the contention of the [taxpayers] that the firm or etched software that is implanted into a computer is not to be taken into account in the valuation thereof for the purpose of excise duty. It is their case that the value of the software, such as discs, floppies, CD ROMs and the like, that they may sell along with the computer is not to be taken into account for the aforesaid purpose.”).

<sup>124</sup>*Second Acer India Case*, (2004) 8 S.C.C. at 186-87 (Justice Sinha for the Court: “Central excise duty cannot be equated with sales tax . . . . [A] “goods” which is not excisable if transplanted into a goods which is excisable would not together make the same excisable goods so as to make the assessee liable to pay excise duty on the combined value of both. . . . There cannot, thus, be any doubt whatsoever that while computing such costs of manufacturing expenses which would add to the value of the excisable goods (in this case the computer) must be taken into consideration but not the value of any other goods which is not excisable.”); *see also PSI Data Systems*, (1997) 2 S.C.C. at 83 (Justice Bharucha for the Court: “A computer may not be capable of effective functioning unless loaded with software such as discs, floppies and CD ROMs, but that is not the say that these are a part of the computer or to hold that, if they are sold along with the computer, their value must form part of the assessable value of the computer for the purpose of excise duty.”).

<sup>125</sup>*Second Acer India Case*, (2004) 8 S.C.C. at 189-93 (Justice Sinha for the Court (at 193): “Once it is held that the computer is complete without the operating softwares, the question of adding the cost of the software therewith would not arise since what is under assessment is only the computers.”).

<sup>126</sup>*Id.* at 194.

tangible personal property or not) was not addressed, as the question did not arise in the case.<sup>127</sup>

### C. *Non-Exigibility of Cloud Computing Transaction to Excise Duty*

This observation is particularly important in the context of Cloud computing. In a Cloud computing transaction, a sale of hardware is not involved. Since excise duty can only be imposed on hardware, and the value of the software sold with the hardware cannot be used to enhance the value of the hardware, the question of application of excise duty to such a transaction cannot arise. A transaction involving a fee charged for the use of software on the Cloud cannot possibly be characterized as “manufacture,” so such a transaction cannot possibly be exigible to excise duties as well. Lastly, the use of software on the Cloud, for which a fee is charged, if not written in the geographical territory of India, could not possibly be exigible to payment of any excise duties as well. This point is important to note because software is classified as excisable items under the excise statutes except the rate of tax on software is “nil” or “zero.”<sup>128</sup> Therefore, writing software is considered “manufacture” and thus exigible to excise duties except the rate of tax is zero therefore practically, and not legally, making it tax-free. If an item is not manufactured within the geographical territory of India, the question of applicability of excise duties to such an item does not arise.<sup>129</sup>

## III. Sales Tax and Cloud Computing Transactions: The *Second TCS Case*

Coming now to the question of sales tax, this Article resumes its discussion of the *First TCS Case*. As was shown before, the correctness of *PSI Data Systems* was questioned in the *First TCS Case* in the context of sales tax and the *First Acer India Case* in the context of excise duties. A unanimous three-judge bench in the *Second Acer India Case* affirmed the *PSI Data Systems* in the context of excise duties.<sup>130</sup> But the dispute in the context of sales tax resulted in the assembly of a Constitution Bench of five judges that delivered its unanimous opinion (a “Lead Opinion” for four judges and a single judge “Concurring Opinion”) in the *Second TCS Case*.<sup>131</sup>

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<sup>127</sup> *Id.* (Justice Sinha for the Court: “We, however, place on record that we have not applied our mind as regards the larger question as to whether the information contained in a software would be tangible personal property or not or whether preparation of such software would amount to manufacture under different statutes.”).

<sup>128</sup> See, e.g., Central Excise Tariff Act, 1985, General Exemption No. 49, Entry 27. Whereas ‘any customized software’ is excisable at ‘NIL’ duty (in other words the rate of tax is zero), ‘packaged software’ is excisable at 10%.

<sup>129</sup> See Gautam, *supra* note 29, at 29.

<sup>130</sup> See *Second Acer India Case*, (2004) 8 S.C.C. at 174.

<sup>131</sup> *Tata Consultancy Servs. v. State of A.P.*, (2005) 1 S.C.C. 308 (India) [hereinafter *Second TCS Case*]. Justice Variava delivered the lead opinion (for Justice N. Santosh Hegde, himself, Justice B. P. Singh and Justice H. K. Sema). Justice S. B. Sinha delivered a concurring opinion completely concurring with the reasoning and the conclusions of the lead opinion.

The Andhra Pradesh General Sales Tax Act, 1957 (A.P. GST Act) defined “goods” as meaning “all kinds of movable property other than actionable claims, stocks, shares and securities.”<sup>132</sup> A “sale” was defined as meaning “every transfer of property in goods.”<sup>133</sup> Explanation IV to section 2(1)(n) (Expl.-IV), a very important provision for our purposes, provided “A transfer of right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration shall be deemed to be a sale.”<sup>134</sup> It is this deeming fiction of law (that assumes a transaction whereby a right to use is transferred to be one of sale for the purpose of levy of sales tax) that this Article will now subject to a closer examination.

Before turning to the Constitution Bench opinion in the *Second TCS Case*, it would be profitable to briefly examine the history behind the deeming fiction in Expl.-IV because the A.P. GST Act is not the only sales tax legislation that has this deeming fiction. Virtually every sales tax legislation in India

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<sup>132</sup>Andhra Pradesh General Sales Tax Act, 1957, § 2(1)(b) (“‘Goods’ means all kinds of movable property other than actionable claims, stocks, shares and securities, and includes all material articles and commodities including the goods (as goods or in some other form), involved in the execution of a works contract or those goods used or to be used in the construction, fitting out, improvement or repair of movable or immovable property and also includes all growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale and also includes motor spirit . . .”).

<sup>133</sup>*Id.* § 2(1)(n) (“Sale with all its grammatical variations and cognate expressions means every transfer of the property in goods whether as such goods or in any other form in pursuance of a contract or otherwise by one person to another in the course of trade or business, for cash, or for deferred payment, or for any other valuable consideration or in the supply or distribution of goods by a society (including a cooperative society), club, firm or association to its members, but does not include a mortgage, hypothecation or pledge of, or a charge on goods.”).

<sup>134</sup>*Id.* § 2(1)(n), Explanation IV.



contains provisions like Expl.-IV.<sup>135</sup> Expl.-IV and its equivalents in other sales tax or VAT legislations potentially provide the State governments a legislative device to deem the license to use a software<sup>136</sup> as a sales transaction even though in truth the transaction is not really a transaction of sales. This point will be elaborated fully later in this Article.

#### A. The “Deemed Sale” Story (To be Continued)

Provisions such as Expl.-IV were not originally a part of the several sales tax legislations that were passed by State Legislatures. By a deeming fiction of law, the State Legislatures were not free to treat any transaction as that of a sale. In 1947 the Madras Legislature amended its sales tax law to deem the transfer of property in a transaction of construction work as sale in order to levy sales tax on the raw material used in such construction works.<sup>137</sup> The amendment was declared ultra vires in the *First Gannon Dunkerley Case*<sup>138</sup> in 1958 by the Supreme Court. And that is where this story begins.

It all started in 1958 with the *First Gannon Dunkerley Case* that was decided by a unanimous Constitution Bench of five judges of the Supreme Court.<sup>139</sup> The dispute in this case predated the adoption of the Indian Constitution and arose from the Government of India Act of 1935.<sup>140</sup> The constitutional

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<sup>135</sup> See, e.g., The Haryana Value Added Tax Act, No. 6 of 2003, § 2(1)(ze)(iv), INDIA CODE (2003) (“sale’ means any transfer of property in goods for cash or deferred payment or other valuable consideration except a mortgage or hypothecation of or a charge or pledge on goods; and includes . . . *the transfer of the right to use any goods for any purpose* (whether or not for a specified period) for cash, deferred payment or other valuable consideration” (emphasis added)); Karnataka Value Added Tax Act, No. 32 of 2004, § 2(29)(d), INDIA CODE (2004) (“Sale’ with all its grammatical variations and cognate expressions means every transfer of the property in goods (other than by way of a mortgage, hypothecation, charge or pledge) by one person to another in the course of trade or business for cash or for deferred payment or other valuable consideration and includes . . . *a transfer of the right to use any goods for any purpose* (whether or not for a specified period) for cash, deferred payment or other valuable consideration” (emphasis added)); Delhi Value Added Tax Act, No. 3 of 2005, §2(zc)(vi), INDIA CODE (2005) (“Sale’ with its grammatical variations and cognate expression means any transfer of property in goods by one person to another for cash or for deferred payment or for other valuable consideration (not including a grant or subvention payment made by one government agency or department, whether of the central government or of any state government, to another) and includes . . . *transfer of the right to use any goods for any purpose* (whether or not for a specified period) for cash, deferred payment or other valuable consideration” (emphasis added)); Maharashtra Value Added Tax Act, No. 9 of 2005 (Levy and Amendment) Act, § 2(24) Explanation (b)(iv), INDIA CODE (2005) (“sale’ means a sale of goods made within the State for cash or deferred payment or other valuable consideration but does not include a mortgage, hypothecation, charge or pledge[,] . . . *the transfer of the right to use any goods for any purpose* (whether or not for a specified period) for cash, deferred payment or other valuable consideration” (emphasis added)).

<sup>136</sup> See *Second Acer India Case*, (2004) 8 S.C.C. 173 (India) at 194; see also *supra* note 91.

<sup>137</sup> See *State of Madras v. Gannon Dunkerley & Co.*, A.I.R. 1958 S.C. 560 (India)[hereinafter *First Gannon Dunkerley Case*].

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

arrangement in the Indian Constitution as regards division of legislative power between the Union Parliament and State Legislatures as described in Part I of this Article<sup>141</sup> was largely based on the division as it was made in Government of India Act of 1935.<sup>142</sup> The dispute in the *First Gannon Dunkerley Case* arose from assessment year 1949–1950 during which the Indian Constitution was still being drafted and the Government of India Act of 1935 was still in force as a provisional constitution.<sup>143</sup> Under the Government of India Act of 1935, State Legislatures had the power to levy “taxes on the sale of goods” under Entry 48 of List II.<sup>144</sup> The taxpayer was a private company engaged in “doing business in the construction of buildings, roads and other works” among others.<sup>145</sup>

The definition of “goods” under the Madras General Sales Tax Act of 1939 (Madras GST Act) had been amended in 1947 to include all materials “used in construction, fitting out, improvement or repair of immovable property or in the fitting out improvement or repair of movable property.”<sup>146</sup> The definition of “sale” was also “enlarged” to include “a transfer of property in goods involved in the execution of a works contract.”<sup>147</sup> A definition of “works contract” was also added whereby “any agreement for carrying out . . . the construction, fitting out, improvement or repair of any building, road, bridge or other immovable property or the fitting out, improvement or repair of any movable property.”<sup>148</sup> In this way the use of movable property in the construction works undertaken by the taxpayers were brought within the ambit of the Madras GST Act.

The validity of these amendments were challenged by the taxpayers on the ground that the power of State Legislatures to levy sales tax under Entry 48 of List II did not extend to imposing a tax on value of materials used in works contracts since there was no transaction of sale involved.<sup>149</sup> The question before the Court, therefore, involved interpretation of the phrase “sale of goods” in Entry 48.<sup>150</sup> After a lengthy discussion of several Indian and foreign

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<sup>141</sup> See *supra* Part I. Constitutional Arrangement.

<sup>142</sup> See AUSTIN, *supra* note 21, at 194-207; Seervai, *supra* note 22, at 164; JAIN, *supra* note 22.

<sup>143</sup> See *First Gannon Dunkerley Case*, A.I.R. 1958 S.C. at 562.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 563 (“The [taxpayers] contest this claim on the ground that the power of the Madras Legislature to impose a tax on sales under Entry 48 in List II in Sch. VII of the Government of India Act does not extend to imposing a tax on the value of materials used in works, as there is no transaction of sale in respect of those goods . . .” (emphasis added)).

<sup>150</sup> *Id.* (“The sole question for determination in this appeal is whether the provisions of the Madras General Sales Tax Act are ultra vires, in so far as they seek to impose a tax on the supply of materials in execution of works contracts treating it as a sale of goods by the contractor, and the answer to it must depend on the meaning to be given to the words “sale of goods” in Entry 48 in List II of Sch. VII of the Government of India Act, 1935.” (emphasis added)).

authorities on the point the Court concluded that, “on the true interpretation of the expression “sale of goods” there must be an agreement between the parties for the sale of the very goods in which eventually property passes.”<sup>151</sup> In absence of such an agreement, a works contract could not be held to be a sale within the meaning of “sale of goods” as used in Entry 48.<sup>152</sup> Therefore the deeming fiction of law in the Madras GST Act whereby transfer of property in works contract was subject to sales tax was held to be beyond the competence of the Madras Legislature.<sup>153</sup> The *First Gannon Dunkerley Case* became the *locus classicus* case in this field.<sup>154</sup>

Then came the 61st Report of the Law Commission of India in 1974<sup>155</sup> that took the view that the interpretation of the expression “sale” in the *First Gannon Dunkerley Case* was unduly restrictive<sup>156</sup> and recommended that a wider definition of the expression “sale” be inserted in Article 366 (the Definitions Clause) of the Constitution.<sup>157</sup> This Article already subjected this recommendation to a critique in an earlier part.<sup>158</sup> In short, the Law Commission’s criticism of the *First Gannon Dunkerley Case* was based on the “principle juridical ground” that the Court in that case failed to follow a principle of constitutional interpretation whereby, “the words used in three Legislative Lists should receive widest possible interpretation.”<sup>159</sup> That was a caveat that was flagged in Part I of this Article. Now is the time give that caveat its heed.

The recommendations of the 61st Report of the Law Commission in 1974 were accepted by the Parliament in 1981 when the Constitution (Forty-Sixth) Amendment Bill was moved and enacted in 1982.<sup>160</sup> The 46th Amendment inserted Article 366 (29A) and inserted six deeming fiction provisions that

<sup>151</sup> *Id.* at 573.

<sup>152</sup> *Id.* (“In a building contract, the agreement between the parties is that the contractor should construct a building according to the specifications contained in the agreement . . . there is in such an agreement neither a contract to sell the materials used in the construction, nor does property pass therein as movables. It is therefore impossible to maintain that there is implicit in a building contract a sale of materials as understood in law.”).

<sup>153</sup> *Id.* at 577 (“To sum up, the expression “sale of goods” in Entry 48 is a nomen juris, its essential ingredients being an agreement to sell movables for a price and property passing therein pursuant to that agreement. In a building contract which is, as in the present case, one, entire and indivisible and that is its norm, there is no sale of goods, and it is not within the competence of the Provincial Legislature under Entry 48 . . . to impose a tax on the supply of the materials used in such a contract treating it as sale . . .”).

<sup>154</sup> See *Bharat Sanchar Nigam Ltd. v. Union of India*, (2006) 3 S.C.C. 1, 27 (India) [hereinafter *BSNL*].

<sup>155</sup> LAW COMMISSION OF INDIA, 61st Report, *supra* note 57.

<sup>156</sup> *Id.* at 20 (¶ 1A.21 contd.).

<sup>157</sup> *Id.* at 21 (¶ 1A.22 (c)).

<sup>158</sup> See *supra* Part I. Constitutional Arrangement.

<sup>159</sup> LAW COMMISSION OF INDIA, 61st Report, *supra* note 57, at 20 (¶ 1A.21 contd.).

<sup>160</sup> This history has been narrated in detail by Justice Ruma Pal in *BSNL*, (2006) 3 S.C.C. at 28.

was noted before<sup>161</sup> that made the holding of the *First Gannon Dunkerly Case* ineffectual to that extent. Now provisions like Expl.-IV could be enacted and transactions that were not sales could be deemed to be sales for the purpose of levying sales tax by State Legislatures. Keeping in mind this short history behind Expl.-IV we must now move on the *Second TCS Case*. Though this Article will return to finish this story in the last part.<sup>162</sup>

### B. *The Second TCS Case and its Implications*

Coming back to the *Second TCS Case*, one remarkable thing to note is the comprehensiveness, and yet the concision, of the opinion. The two opinions delivered in this case span a total of 34 printed pages in the law report Supreme Court Cases<sup>163</sup> and cite a total of 51 Indian and foreign judicial opinions.<sup>164</sup> There is much to be said about the citations of foreign precedents by the Constitution Bench in this case—a question of increasing practical significance nowadays—but such a critical inquiry is beyond the stated brief of this Article.

The taxpayers in this case were selling “uncanned software” (*i.e.*, custom made software) and “canned software” (*i.e.*, off the shelf ready made software) as a part of their computer consultancy service.<sup>165</sup> Revenue authorities had imposed sales tax on canned software on the ground that these were goods (that was subsequently upheld on appeal by the Appellate Deputy Commissioner, then on further appeal by the Sales Tax Appellate Tribunal and lastly on revision by the Andhra Pradesh High Court).<sup>166</sup> On appeal and subsequent Constitution Bench reference before the Supreme Court, the question was, “whether the canned software sold by the [taxpayers] can be termed to be ‘goods’ and as such assessable to sales tax” under the A.P. GST Act.<sup>167</sup>

Because of the limitation arising as a result of the deeming fiction in Expl.-IV, the taxpayers had argued that computer software is not goods as defined in the A.P. GST Act.<sup>168</sup> Reliance was placed on the technical definition of a software,<sup>169</sup> the legal definition of a software under the Copyright

<sup>161</sup> See *supra* Part I. Constitutional Arrangement.

<sup>162</sup> See *infra* Part IV.A.

<sup>163</sup> *Second TCS Case*, (2005) 1 S.C.C. at 304-42.

<sup>164</sup> *Id.* at 314-16 (Chronological list of cases cited).

<sup>165</sup> *Id.* at 316.

<sup>166</sup> *Id.*

<sup>167</sup> *Id.* at 316, 330 (Justice Sinha framed the question as, “Whether an intellectual property contained in floppies, disks or CD-ROMs would be “goods” within the meaning of Andhra Pradesh General Sales Tax Act?”).

<sup>168</sup> *Id.* at 318-19 (“[Taxpayer] submitted that . . . having regard to its nature and inherent characteristic, software is intangible property which cannot fall within the definition of the term “goods” in Section 2(1)(b) of the said Act.”).

<sup>169</sup> *Id.* at 318-19 (citing two textbooks on computer software in support of this assertion).

Act of 1957<sup>170</sup> and judicial opinions delivered by “American Courts.”<sup>171</sup> It should be noted here that the taxpayers never argued that Expl.-IV should be read restrictively and in its proper context. This point is elaborated upon later. However, to be fair, in the face of a legislative provision like Expl.-IV one could not fault the taxpayers for making a strategic decision to argue their case based only on a restrictive interpretation of “goods” as defined in the A.P. GST Act. A later part of this Article argues that provisions like Expl.-IV should be read and understood in their proper historical context and a mere textual interpretation of provisions like Expl.-IV is neither desirable nor correct.<sup>172</sup>

Revenue naturally contended that “all kinds of movable property” is considered “goods” under the A.P. GST Act, and that the distinction between a tangible or intangible property is not relevant.<sup>173</sup> For instance, Revenue argued that “incorporeal rights, like copyright or an intangible thing like electric energy,<sup>174</sup> were regarded as goods exigible to sales tax and, therefore, entitlement to a right to participate in a draw,<sup>175</sup> which was beneficial interest in movable property, would fall within the definition of ‘goods.’”<sup>176</sup> On this authority, it was argued that, “similar would be the position in the case of a [software] of any kind loaded on a disc or a floppy.”<sup>177</sup>

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<sup>170</sup> *Id.* at 319; *see also* The Copyright Act, 1957, No. 14, of 1957, INDIA CODE (2014) § 2 (*ffc*) (“‘computer software’ means a set of instructions expressed in words, codes, schemes or in any other form; including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result.”).

<sup>171</sup> *Id.* at 319-21. In all these American cases, Justice Variava observed, it had been held that, “‘computer software’ is intangible personal property” on the ground that, “the information contained in the software programs can be introduced into the user’s computer by several different methods . . . .” This point had been noted by a Division Bench of the Court in *PSI Data Systems* and subsequently affirmed by a three-judge bench in the *Second Acer India Case*. Justice Variava also observed that the American cases recognized the distinction between a software and medium used for transmitting the software into the computer.

<sup>172</sup> *See infra* Part IV.

<sup>173</sup> *Second TCS Case*, (2005) 1 S.C.C. at 322.

<sup>174</sup> *Id.* at 322-24. *See also* Commissioner of Sales Tax v. M.P. Elec. Bd., (1969) 1 S.C.C. 200 (India); State of A.P. v. Nat’l Thermal Power Corp. Ltd., (2002) 5 S.C.C. 203 (India); M.P. Cement Manufacturers’ Assn. v. State of M.P., (2004) 2 S.C.C. 249 (India); INDIA CONST. art. 246, Seventh Schedule, List II—State List, Entry 53—“Taxes on the consumption or sale of electricity.”

<sup>175</sup> *Second TCS Case*, (2005) 1 S.C.C. at 323. *See also* H. Anraj v. Gov’t of Tamil Nadu, (1986) 1 S.C.C. 414 (India), INDIA CONST. Schedule 7, List II—State List, Entry 62—“Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.”

<sup>176</sup> *Second TCS Case*, (2005) 1 S.C.C. at 323.

<sup>177</sup> *Id.* at 326. *See also* *State Bank of India v. Collector of Customs*, (2000) 1 S.C.C. 727 (India), denying application for refund of customs duty amounting to US \$3,683,428, on the ground that the basic cost of the software was only US \$401,047. The ground for seeking refund was that the customs duty could only be imposed on the basic cost of the software and not the technical material supplied with the software in form of drawings or manuals. The Court rejected the argument, holding the customs duty was leviable on the “transaction value” which had to include the value of supplemental drawings and manuals.

After an elaborate discussion of the competing arguments and authorities cited in support, the Lead Opinion gave its decision in favor of the Revenue, rejecting the tangible-intangible distinction made by the taxpayers.<sup>178</sup> In the law report Supreme Court Cases, this holding of the Lead Opinion is recorded in paragraph 27 of the opinion (with which the Concurring Opinion concurs completely<sup>179</sup>) and is hereinafter referred to as “Para 27.” Para 27 must be subjected to closer inspection.

In the context of a Cloud computing transaction, the question would not be covered by Para 27 specifically or the *Second TCS Case* generally. This is because, unlike the sale of software as transacted in the *Second TCS Case*, in a Cloud computing transaction, there is no “sale” of software in that sense of the expression. The transfer of the intellectual property in the software, in the context of the *Second TCS Case*, is via media on which the software is stored. In the words of the Lead Opinion, “In all such cases, the intellectual property has been *incorporated on a media* for the purpose 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.*”<sup>180</sup> The central pillar of holding in Para 27 is therefore this incorporation of the software onto the media. This is the first key distinction between a transfer of intellectual property in the software on the Cloud versus the transfer of intellectual property in the software as it was in the *Second TCS Case*.

Note that in all these cases, the Court has not once rejected the dualism between software and the medium used to store, carry and transmit the software. If the software and the medium used to store, carry and transmit the software are in theory and indeed two distinct things, and if the sale of a software is to be exigible to sales tax by virtue of it being transferred post its incorporation on the medium (for that is the only way it could be transferred), in absence of such an incorporation on the media, it is hard to see by what line of logic can a Cloud computing transaction be covered by the *Second TCS Case's* holding in Para 27.

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<sup>178</sup> *Second TCS Case*, (2005) 1 S.C.C.at 329, 331 (“In our view, the term “goods” as used in Article 366(12) of the Constitution and as defined in the [A.P. GST Act] is very wide and includes all types of movable properties, whether those properties be tangible or intangible. . . . *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 the purpose of transfer. . . .* 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 programs have all these attributes.” (emphasis added)). Justice Sinha observed that, “If a distinction is sought to be made between tangible and intangible properties, material, commodities and articles and also corporeal and incorporeal materials, the definition of goods will have to be rewritten of comprising tangible goods only which is impermissible.” *Id.* at 342 (Sinha, J., concurring).

<sup>179</sup> *Id.* at 342.

<sup>180</sup> *Id.* at 329 (emphasis added).

This point is further supported by the 2008 Division Bench opinion delivered by the Supreme Court in *Imagic Creative (P) Ltd. v. Commissioner of Commercial Taxes*.<sup>181</sup> This case arose out of the Karnataka Value Added Tax Act, 2003 (Karnataka VAT Act). The taxpayer was an advertising agency providing advertisement services.<sup>182</sup> The question before the Court was, “Whether the charges collected towards the services for evolution of prototype conceptual design (*i.e.*, creation of concept), on which service tax had been paid under the Finance Act, 1994 . . . are liable to tax under the [Karnataka VAT Act]?”<sup>183</sup> Revenue authorities had levied value added tax on the sale of advertisement material on the ground that the contract for providing advertisement service and the sale of advertisement material was an indivisible contract.<sup>184</sup> On appeal the Karnataka High Court affirmed.<sup>185</sup> On further appeal before the Supreme Court, the taxpayers argued that:

[T]he service element [of the contract] being subject to service tax, no sales tax could have been levied on the incidental transfer of goods unless such transfer falls within the scope and ambit of the provisions contained in sub-clause (a) to (f) of Clause (29-A) of Article 366 of the Constitution of India.<sup>186</sup>

The Court referred to the *Second TCS Case* and restated the principle laid down in Para 27.<sup>187</sup> For the purpose of Article 366(12) of the Indian Constitution, software would be “goods” as defined therein, but the copyright in that program remains with the creator of the program.<sup>188</sup> However, in order for sales tax to be levied on the transfer of the software they must become “goods” within the meaning of the sales tax law and they so become only when “copies are made and marketed.”<sup>189</sup> This is an extremely important point that sheds immense light on the true scope of Para 27.

The dualism between the intellectual property in the software and the physical existence of the software on some external medium used to store data in digital form was first judicially recognized by the Court in *PSI Data Systems*<sup>190</sup> and then all subsequent cases continue to recognize this

<sup>181</sup> (2008) 2 S.C.C. 614 (India) [hereinafter *Imagic Creative*].

<sup>182</sup> *Id.* at 617.

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 620, 622.

<sup>185</sup> *Id.* at 620-22.

<sup>186</sup> *Id.* at 621.

<sup>187</sup> *Id.* at 623.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* (“We may also notice that a Constitution Bench of this Court in [the Second TCS Case] opined that having regard to the definition of the term “goods” contained in Clause (12) of Article 366 of the Constitution of India, a software program may consist of various commands which enable the computer to perform a designated task. The copyright in that program may remain with the originator of the program, *but the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax.*” (emphasis added)).

<sup>190</sup> See *PSI Data Systems*, (1997) 2 S.C.C. at 80, 83.



distinction.<sup>191</sup> Sales tax was attracted to the transfer of intellectual property in the software because of the transfer by way of incorporation of the software on the media.<sup>192</sup> Obviously, a mere transfer of the software to the media cannot be characterized as a sale. Now, if sales tax can be levied on the transfer of intellectual property in the software only upon the event of the software being transferred onto a physical media and thus marketed, this physical media becomes the intervening event on which sales tax is leviable.

In absence of this intervening event, two questions would arise. First, would a sales tax on the transfer of software in absence of such media be leviable on a transfer of intellectual property in the software? This question arises when the software is directly downloaded on to the computer without any intervening media. An example would be the downloading of an app from the Apple App-Store directly on to your MacBook or iPad. Another example could be you paying a monthly or yearly subscription fee to subscribe to a Cloud computing service in order to use software on the Cloud. Second, would the transactions as described above be covered by the *Second TCS Case's* holding in Para 27?

Taking the second question first, for the reasons mentioned above, the *Second TCS Case* cannot apply. Because the central pillar of the holding in the *Second TCS Case*, subsequently followed in *Imagic Creative*, is the presence of the intervening event of the physical media as the mode of marketing the intellectual property in the software, the absence of such an intervening event in the transaction as described above would remove such transactions from the scope of Para 27 in the *Second TCS Case*.

Coming now to the first question—the answer depends on two independent subsequent questions that must necessarily arise. First, is software “goods”? In other words, can software be described as goods as traditionally understood in a legal sense? If the conclusion is that it can, without unduly or artificially expanding the long standing definition of goods, then the logical conclusion is that if software is goods, and goods can be sold, a sale of software is exigible to a sales tax. If, however, it is concluded that software cannot come within the definition of goods except by creating a highly artificial deeming fiction of law, then the next logical question would be whether it is desirable to do so. This question requires closer and independent examination that is beyond the stated brief of this Article. Second, what is the true legal meaning of the expression “sale” of software? In other words, can software be truly “sold” as the expression “sale” is understood in commercial parlance? If software cannot be sold as the phrase “sale” is traditionally understood, then notwithstanding the fact that they are goods or not sales tax cannot be levied because a sales tax is a tax on a transaction of sale. If one concludes that software cannot be “sold” as the expression is legally understood, except, again,

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<sup>191</sup> See *ORG Systems*, (1998) 6 S.C.C. 56 at 60; see also *Second Acer India Case*, (2004) 8 S.C.C. at 194 and *Second TCS Case*, (2005) 1 S.C.C. at 329.

<sup>192</sup> See *Second TCS Case*, (2005) 1 S.C.C. at 329.

by using an artificial deeming fiction of law, then the next logical question would be: Is it desirable to do so? Again, this is a question worth deeper and independent examination but is beyond the stated brief of this Article. It is to a closer examination of these questions that the last part of this Article is devoted.

#### IV. “Sale” of “Goods” in India and Cloud Computing Transactions

What constitutes “goods” and what constitutes a “sale”? In the context of the sales tax law, in the opinion of this author, it would not be an exaggeration to state that this perhaps has been one of the most heavily contested questions. How is it to be determined whether something is “goods” and how is it to be determined whether a transaction is a “sale”? Those are questions that have been litigated before the Supreme Court of India time and again. Most of the time the Supreme Court has interpreted the Constitution and the laws it has found in favor of the taxpayers. And every single time the Supreme Court has found in favor of the taxpayers the Parliament has responded with either legislation or a constitutional amendment that enables the legislatures to levy tax on transactions that the Supreme Court held were beyond the purview of sales taxation. This history of this back and forth between the Parliament and the Supreme Court has been noted and narrated in several leading Supreme Court opinions.<sup>193</sup> It is worth briefly going through this tale once again.

There are two sides to this story. First, what are those transactions of “sale” on which sales tax can be imposed by State Legislatures? Second, when can States impose those taxes? To be specific—can a sales tax be imposed on the “transfer of a right to use” to the goods? There is of course the allied question—what are “goods”? These questions will all be addressed. The first question has already been addressed above.<sup>194</sup>

##### A. *The “Deemed Sale” Story Continued*

Picking up the story from where it was left at the end of Part III-B, one must examine the leading post 46th Amendment decisions where 46th Amendment itself was subject to interpretation. It was anticipated that the insertion of the six deeming fictions by Article 366 (29A) would resolve this conflict but that unfortunately did not happen.

The first important post-46th Amendment decision was given in *Builders’ Ass’n of India v. Union of India*<sup>195</sup> by a unanimous Constitution Bench of five judges of the Supreme Court of India. The dispute in this case involved a

<sup>193</sup> See, e.g., *Builders’ Ass’n of India v. Union of India*, (1989) 2 S.C.C. 645, 658-64 (India); *20th Century Fin. Corp. Ltd. v. State of Maharashtra*, (2000) 6 S.C.C. 12, 30-36 (India); *Bharat Sanchar Nigam Ltd. v. Union of India*, (2006) 3 S.C.C. 1 (India).

<sup>194</sup> See *supra* Part III.

<sup>195</sup> (1989) 2 S.C.C. 645 (India) [hereinafter *Builders’ Ass’n*].

question on the constitutional validity of the 46th Amendment.<sup>196</sup> The validity of the 46th Amendment was upheld,<sup>197</sup> and the discussion of that is not relevant to this Article.<sup>198</sup> The judicial and legislative history behind the 46th Amendment was duly noted by the Court.<sup>199</sup> It was the 46th Amendment that gave the State Legislatures the requisite legislative competence to levy sales tax of works contracts.<sup>200</sup> An issue arose as to whether this new power granted under 46th Amendment is subject to other restrictions provided in the Constitution.<sup>201</sup> One of the restrictions that was particularly pressed into service was Article 286 of the Indian Constitution. As per Article 286(1), the State Legislatures are not allowed to impose sales tax on inter-State sales.<sup>202</sup> Relying on Article 286(1), and in the context of works contracts, the taxpayers argued:

*The 46th Amendment has no bearing on the location of the sale. It does not deem an outside sale to be an inside sale. It does not confer on the States the power to tax sales outside the State. Therefore, if in the process of executing a works contract, a transfer of property in the goods takes place outside the State, the State would have no power to levy sales tax on such a transfer.*<sup>203</sup>

It is the italicized portion of this argument, and the consequent holding on this point, that is relevant for our discussion in the context of this Article.

Construing the expression “tax on sale or purchase of goods” (as it appears in Entry 54, State List, Schedule VII of the Indian Constitution) the unanimous five-judge bench held that this expression

includes 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 . . . . The tax leviable by virtue of sub-clause (b) of clause (29-A) of Article 366 of the

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<sup>196</sup> *Id.* at 651 (“The first question relates to the constitutional validity of the Constitution (Forty-sixth Amendment) Act, 1982 . . .”).

<sup>197</sup> *Id.* at 666.

<sup>198</sup> The amendment was challenged on a procedural ground that the requisite number of State Legislatures had not ratified the amendment. It was shown before the Court that they had.

<sup>199</sup> *Builders’ Ass’n*, (1989) 2 S.C.C. at 658-64.

<sup>200</sup> *Id.* at 664 (“On the passing of 46th Amendment the State Governments after making necessary amendments in their laws commenced to levy sales tax on the turnover of the works contracts entered into by the building contractors for constructing houses, factories, bridges etc.”).

<sup>201</sup> *Id.* at 665 (“The petitioners and the appellants have pressed before us in these cases only two points . . . (ii) that it was not open to the States to ignore the provisions contained in Article 286 of the Constitution and the provisions of the Central Sales Tax Act, 1956 while making assessments under the sales tax laws passed by the legislatures of the States.”).

<sup>202</sup> INDIA CONST. art. 286, § 1 (“No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place –

(a) outside the State; or

(b) in the course of the import of goods into, or export of goods out of, the territory of India”).

<sup>203</sup> *Builders’ Ass’n*, (1989) 2 S.C.C. at 667 (emphasis added).

Constitution thus becomes subject to the same discipline to which any levy under entry 54 of the State List is made subject to under the Constitution.<sup>204</sup>

Therefore, “all transfers, deliveries and supplies of goods referred to in [Article 366 (29A) (a) to (f)] are subject to the restrictions and conditions mentioned in [Article 286].”<sup>205</sup> Accordingly, “[i]f the power to tax a sale in an ordinary sense is subject to certain conditions and restrictions imposed by the Constitution, the power to tax a transaction which is deemed to be a sale under Article 366(29-A) of the Constitution should also be subject to the same restrictions and conditions.”<sup>206</sup> The principles of law laid down in *Builders’ Ass’n* are as much a part of the constitutional law of India as they are a part of India’s sales tax law.

There are two rules that emerge very clearly from *Builders’ Ass’n*. The first is that the six deeming fictions of Article 366(29A) are not equivalent to legislative entries in Schedule VII.<sup>207</sup> The deeming fictions of Article 366(29A) are to be used to interpret the legislative entries in Schedule VII. In and of themselves they do not give any legislative competence to the State Legislatures. That competence necessarily comes from Article 246 read with the relevant legislative entry in the applicable list. The second is that these six deeming fictions (that enlarge the scope of transactions on which sales tax may be levied by declaring that which is not a sale to be a sale) are subject to substantive restrictions that are to be found in other provisions on the Constitution. This Article will later how these two rules apply to Cloud computing transactions.

### B. Taxing “Transfer of Right to Use” and Cloud Computing

Moving on to the next important case, one should examine *20th Century Finance*,<sup>208</sup> which was decided in 2000 by a Constitution Bench of five judges. The constitutional provision that became the focal point of the controversy in this case was Article 366(29A)(d)<sup>209</sup>—the very provision that we have noted before<sup>210</sup> is the constitutional provision behind Expl.-IV. To quickly rehash, Expl.-IV was the provision in the A.P. GST Act whereby a “right to use” could be deemed to be a sale.<sup>211</sup> Naturally, it is important to note how Article 366(29A)(d) has been interpreted by the Supreme Court. The taxpayer in this

<sup>204</sup> *Id.* at 669.

<sup>205</sup> *Id.* at 670.

<sup>206</sup> *Id.* at 673.

<sup>207</sup> *Id.* at 674. (“We do not accept the argument that [Article 366 (29A)(b)] should be read as being equivalent to a separate entry in List II of the Seventh Schedule to the Constitution enabling the State to levy tax on sales and purchases independent of entry 54 thereof.”).

<sup>208</sup> *20th Century Fin. Corp. Ltd. v. State of Maharashtra*, (2000) 6 S.C.C. 12 (India) [hereinafter *20th Century Finance*].

<sup>209</sup> *Id.* at 26 (“[T]he controversy as regards the power of the State Legislatures to levy sales tax under [Article 366(29A)(d)] in the context of the question where is the taxable event on the transfer of right to use any goods remains unresolved.”).

<sup>210</sup> See *supra* Part III.

<sup>211</sup> See *supra* note 132 and accompanying text.

case was a company carrying on the “business of leasing diverse equipment.”<sup>212</sup> To put it simply, the taxpayer took the order from “the party who desired to take equipment for use on hire” and then delivered “the equipment to the lessee at the specified locations for use.”<sup>213</sup> The taxpayer’s grievance was that “one transaction of transfer of right to use goods [was being] subjected to sales tax by more than one State.”<sup>214</sup>

The key argument made by the taxpayer in this case was remarkably similar in tone and style to the arguments taken by the taxpayer in *Builders’ Ass’n*.<sup>215</sup> At the heart of this argument is the central idea that the limitations on taxing power of State Legislatures that come out of other provisions of the India Constitution have not been overcome by the 46th Amendment. In 1989, this view was first accepted by the Constitution Bench in *Builders’ Ass’n*, and in 2000 it was once again accepted<sup>216</sup> when it was held that “State Legislatures are not competent to enact law imposing tax on the transactions of transfer of right to use any goods which take place in the course of inter-State trade or commerce.”<sup>217</sup> The rest of this opinion was devoted to the issue that arose on the facts of the case (*i.e.*, where is the situs of sale in transactions of the sort involved in this case and how is that situs to be determined).<sup>218</sup> An examination of the discussion on the point is not relevant here, though one may note the following holding, which if read along with the key holding in the *Second TCS Case* gives considerable guidance in the case of Cloud computing. It was held that:

[T]he transfer of the right to use any goods will be a deemed sale in the case of [Article 366(29A)(d)] cannot, in our view, be read as implying that the tax under [Article 366(29A)(d)] is to be imposed not on the transfer of the right to use goods but on the delivery of the goods for use.<sup>219</sup>

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<sup>212</sup> *20th Century Finance*, (2000) 6 S.C.C. at 27.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* at 29 (“[Taxpayers] urged that there are two independent limitations upon the taxing power of the State based on situs of the sale – one is grafted in Article 286 and the other where the sale occurs within the State, it cannot by virtue of Entry 54 of List II read with Entry 92-A of List I levy a tax on a sale which is in the course of inter-State trade or commerce . . .”). Compare this argument with that taken in *Builders’ Ass’n*, (1989) 2 S.C.C. at 664 (“The petitioners and the appellants have stressed before us in these cases . . . (ii) that it was not open to the States to ignore the provisions contained in Article 286 of the Constitution and the provisions of the Central Sales Tax Act, 1956 while making assessments under the sales tax laws passed by the legislatures of the State.”).

<sup>216</sup> *Builder’s Ass’n*, (2000) 6 S.C.C. at 36.

<sup>217</sup> *Id.* (“[W]e are of the view that the power of State Legislatures to enact law to levy tax on the transfer of right to use any goods under Entry 54 of List II of the Seventh Schedule has two limitations—one arising out of the entry itself; which is subject to Entry 92-A of List I, and the other flowing from the restrictions embodied in Article 286.”).

<sup>218</sup> *Id.* at 37, 39, 40-42.

<sup>219</sup> *Id.* at 41.

Therefore, the taxable event in context of Article 366(29A)(d) is the transfer of the right and not the delivery of the goods.<sup>220</sup>

In the context of the *Second TCS Case*, as was noted above, the central pillar of its key holding in Para 27 is the transfer of the intellectual property in the software via a media on which the software is stored. In the words of the Lead Opinion, “In all such cases, the intellectual property has been *incorporated on a media* for the purpose 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.*”<sup>221</sup> The central pillar of holding in Para 27 is therefore this incorporation of the software onto the media.

Now, in the context of Cloud computing, if we read Para 27 of the *Second TCS Case* along with above noted holdings in *20th Century Finance* the legal position that emerges will be as follows. If the taxable event, per *20th Century Finance*, in the case of Article 366(29A)(d), is the transfer of the right to use and if, per Para 27 of the *Second TCS Case*, the transfer of the right to use the software is contingent on the presence of a media via which such transfer occurs, then in absence of such a media it cannot be said that a transfer of the right has actually occurred. If there is no transfer of right to use then how can the State Legislatures levy sales tax on a cloud computing transaction where the subscriber pays a fee to use the software on the Cloud? This Article submits that they cannot.

Furthermore, this Article submits that a strict analogy between the facts of the *Second TCS Case* and a Cloud computing transaction does not exist and as such Para 27 of the *Second TCS Case* cannot be read as giving the State Legislatures the requisite constitutional legislative competence to impose sales tax on cloud computing transactions.<sup>222</sup> Whereas when software is sold via media, as was the case in the *Second TCS Case*, the consumer receives a copy of the software. But on the Cloud the consumer never receives any copy of the software.<sup>223</sup>

### C. The “Goods” Story

The points made in the last two paragraphs, especially the second last paragraph, might seem like a novel point to many readers. But that is not so. A similar point, though in another context, was made in 2006 in *Sunrise*

<sup>220</sup> *Id.* (“Article 366(29A)(d) further shows that levy of tax is not on use of goods but on the transfer of the right to use goods. *The right to use goods accrues only on account of the transfer of right. In other words, right to use arises only on the transfer of such a right and unless there is a transfer of right, the right to use does not arise.*” (emphasis added)).

<sup>221</sup> *Second TCS Case*, (2005) 1 S.C.C. at 329 (emphasis added).

<sup>222</sup> See Raffi Melanson, *Sales Tax and the Shadow of Cloud Computing: Searching the Horizon for a Workable, National Solution*, 65 *Tax. Law.* 871, 880 (2012). Melanson notes that, “The strict analogy between traditional software and Cloud computing continues to break down when looking for a transfer of property. With the traditional model of software, the consumer receives one copy of the software, regardless of the mode of delivery. But with Cloud computing, users generally never receive a copy of the software.” *Id.*

<sup>223</sup> *Id.* (noting that in a Cloud computing transaction, “there is no delivery or transfer”).

*Associates*.<sup>224</sup> This case was decided by a unanimous Constitution Bench of five judges. The question in this case was the levy of sales tax on lottery tickets.<sup>225</sup> In a previous case, *Anraj*,<sup>226</sup> such a levy was upheld, but this case overruled *Anraj*.<sup>227</sup> While analyzing *Anraj* the Court in *Sunrise Associates* made an observation that has striking similarity with Para 27 of the *Second TCS Case*.

In the context of lottery tickets, the *Sunrise Associates* bench observed that the judges in *Anraj*

agreed that the right to participate in the draw under a lottery ticket was a valuable right and that lottery tickets, not as physical articles but as slips of paper or memoranda evidencing the right to participate in the draw can be regarded as dealer's merchandise and, therefore, goods which are capable of being bought or sold in the market.<sup>228</sup>

In context of a right to use being transferred in a software via media, the *Second TCS Case* bench had observed, "Sale is not just of the media which by itself has very little value."<sup>229</sup> Therefore like a lottery ticket gets its value from the right that that piece of paper represents, absent which it has no or very little value,<sup>230</sup> similarly the media (a CD-ROM for example) that carries the software in which a right to use has been transferred derives its value from the right that the media represents, absent which it has no or very little value. The taxpayers in *Sunrise Associates* attacked *Anraj* on the ground that it artificially drew a distinction between a right to participate in the draw and the chance to win the prize.<sup>231</sup> The decision was given in favor of the taxpayer in *Sunrise Associates* because the Court determined a lottery ticket to be an "actionable claim" that was not defined as "goods" as per the applicable sales tax legislation.<sup>232</sup>

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<sup>224</sup> *Sunrise Assocs. v. Gov't of NCT of Delhi*, (2006) 5 S.C.C. 603 (India).

<sup>225</sup> *Id.* at 609.

<sup>226</sup> *H. Anraj v. Gov't of Tamil Nadu*, (1986) 1 S.C.C. 414 (India).

<sup>227</sup> *Sunrise Associates*, (2006) 5 S.C.C. at 624 (Justice Ruma Pal for the Court: "We are therefore of the view that the decision in *H. Anraj* incorrectly held that a sale of lottery ticket involved a sale of goods.")

<sup>228</sup> *Id.* at 614.

<sup>229</sup> *Second TCS Case*, (2005) 1 S.C.C. at 329.

<sup>230</sup> *Sunrise Associates*, (2006) 5 S.C.C. at 619, 621 ("The lottery ticket per se [has] no innate value . . . . It is a mere piece of paper. Its value lies in the fact that it represents a chance or a right to a conditional benefit of winning a prize of a greater value than the consideration paid for the transfer of that right." (emphasis added)).

<sup>231</sup> *Id.* at 616.

<sup>232</sup> *Id.* at 620 ("We have noted earlier that all the statutory definitions of the word "goods" in the State sales tax laws have uniformly excluded, inter alia, actionable claims from the definition for the purposes of the Act . . . . Consequently, an actionable claim is movable property in the wider sense of the term but a sale of an actionable claim would not be subjected to the sales tax laws"); *id.* at 622 ("The question is, what is this right which the ticket represents? . . . The right would fall squarely within the definition of an actionable claim and would therefore be excluded from the definition of "goods" under the Sale of Goods Act and the sales tax statutes.").



To take another example, one may examine the 2006 Division Bench (two judges) opinion delivered in *Kalyana Mandapam*.<sup>233</sup> This case was in the context of service tax, which one may recall can only be levied by the Union Parliament specifically under Entry 92C<sup>234</sup> or even otherwise under Entry 97<sup>235</sup> of the Union List in Seventh Schedule. In 1994, the Indian Parliament enacted the Finance Act of 1994 whereby a service tax was levied on several services but the legislation was enacted under Entry 97.<sup>236</sup> In 1997, caterers<sup>237</sup> and “mandap-keepers”<sup>238</sup> were within the ambit of service tax. A “mandap” was defined as “any immovable property as defined in Section 3 of the Transfer of Property Act, 1884 . . . and includes any furniture, fixture, light fittings and floor coverings therein let out for consideration for organizing any official, social or business function.”<sup>239</sup> Accordingly, a Service Tax Notice was issued whereby service tax was levied on “any open land/ground if the same [was] let out for organising any official, social or business function, even if no accompanying/incidental services were rendered by the mandap-keeper to the clients hiring the open land/ground for any of abovementioned purposes.”<sup>240</sup> This was challenged by the taxpayers as unconstitutional on the grounds that this was a colorable exercise of legislative power by the Parliament.<sup>241</sup> The taxpayers argued inter alia that a levy of service tax on letting out any open land or ground is not a tax on the service provided by the mandap-keeper but, “is in fact a tax on land per se which is a subject specifically earmarked for the State Legislatures under Entries 18 and 49 of List II of the Constitution.”<sup>242</sup>

<sup>233</sup>T. N. Kalyana Mandapam v. Union of India, (2004) 5 S.C.C. 632 (India).

<sup>234</sup>INDIA CONST. art. 246, Seventh Schedule, List I—Union List, Entry 92C—“Taxes on Services” (amended by The Constitution (Eighty-Eighth Amendment) Act, 2003).

<sup>235</sup>*Id.* art. 246, Seventh Schedule, List I—Union List, Entry 97—“Any other matters not enumerated in List II or List III including any tax not mentioned in either of those lists.”

<sup>236</sup>*Kalyana Mandapam*, (2004) 5 S.C.C. at 637 (“Service tax was introduced in India vide the Finance Act, 1994. Service tax is legislated by Parliament under the residuary entry i.e. Entry 97 of List I of the Seventh Schedule of the Constitution of India.”).

<sup>237</sup>The Finance Act, 1994, No. 32, of 1994, Acts of Parliament, 1994 (India) § 65(24) (“caterer’ means any person who supplies either directly or indirectly, any food, edible preparations, alcoholic or non-alcoholic beverages or cookery and similar article or accouterments for any purpose or occasion;”).

<sup>238</sup>*Id.* § 65(20) (“‘mandap-keeper’ means a person who allows temporary occupation of a mandap for consideration for organizing any official, social or business function;”).

<sup>239</sup>*Id.* § 65(19).

<sup>240</sup>*Kalyana Mandapam*, (2004) 5 S.C.C. at 640.

<sup>241</sup>*Id.* at 641.

<sup>242</sup>*Id.* (emphasis added).

The arguments were rejected as the levy was upheld.<sup>243</sup> While upholding this levy a particularly useful observation was made by the Court that one may profitably note—“a levy of a service tax on a particular kind of service could not be struck down on the ground that it does not conform to a common understanding of the word “service” so long as it does not transgress any specific restriction contained in the Constitution.”<sup>244</sup>

On the strength of *Kalyana Mandapam*, therefore, it may be argued that keeping in mind the nature of a cloud computing transaction, the most apt characterization of these kinds of transactions is that of a service and not that of a sale. In *Kalyana Mandapam* the Court used the “nature and character test” in order to characterize the transaction on which a service tax was levied.<sup>245</sup> Now, what is the nature and character of a Cloud computing transaction? It is a generic term that covers three distinct categories of services: “Software as a Service” (SaaS), “Platform as a Service” (PaaS) and “Infrastructure as a Service” (IaaS).<sup>246</sup> This characterization of Cloud computing as a bundle of services comes from a reliable expert source.<sup>247</sup> However, as to the question at hand, and in light of all the Indian judicial authorities on the point, two points emerge—(1) unless undue liberties are taken with the deeming fiction created under Article 366(29A)(d) of the Indian Constitution, a Cloud computing transaction cannot be characterized as that of a sale so as to enable State Legislatures to levy sales tax on such transactions; and (2) as to Cloud computing being a service, though it is beyond the stated brief of this Article to do into a detailed examination of this question, a preliminary review of literature on the point does show that there is growing consensus among experts that Cloud computing is a transaction where services are rendered to clients and does not involve the sale of any goods. This is a question that must be examined closely.

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<sup>243</sup> *Id.* at 650-51 (“In fact, making available a premises for a period of a few hours for the specific purpose of being utilised as a mandap whether with or without other services would itself be a service and cannot be classified as any other kind of legal concept. It does not certainly involve transfer of movable property nor does it involve transfer of movable property of any kind known to law either under the Transfer of Property Act or otherwise and can only be classified as a service... a tax on services rendered by mandap-keepers and outdoor caterers is in pith and substance a tax on services and not a tax on sale of goods or on hire-purchase activities.”).

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* at 652 (“The nature and character of this service is evident from the fact that the transaction between a mandap-keeper and his customer is definitely not in the nature of a sale or hire-purchase of goods. It is essentially that of providing a service.”).

<sup>246</sup> Peter Mell & Tim Grance, THE NIST DEFINITION OF CLOUD COMPUTING, RECOMMENDATIONS OF THE NATIONAL INSTITUTE OF STANDARDS AND TECHNOLOGY, NIST Special Publication 800-145, at 2-3, Sept. 2011, <http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf> [hereinafter NIST Definition].

<sup>247</sup> The NIST definition has been relied on, cited favorably, or both by several articles that have been published on the subject to sales taxation of Cloud computing in the West. *See, e.g.*, Manzur, *supra* note 7, at 2; Melanson, *supra* note 222, at 875; Tuan Q. Ngo, *Cloud Computing and State Sales Tax*, 9 HASTINGS BUS. L. J. 327, 330 (2013).

Taking the second point first, to elaborate the question at hand (*i.e.*, whether any sales tax is leviable in Cloud computing transactions) one may consider a few more examples. Take for instance the following observation in *Kalyana Mandapam*:

A customer goes to a mandap-keeper, say a star hotel, not merely for the food that it will provide but the entire variety of services provided therein which result in providing the function to be solemnized with the required effect and ambience. Similarly the services rendered by outdoor caterers is clearly distinguishable from the services rendered in a restaurant or hotel inasmuch as, in the case of outdoor catering service the food/eatables/drinks are the choice of the person who partakes of the services . . . . *Clearly, the service element is more weighty, visible and predominant in the case of outdoor catering. It cannot be considered as a case of sale of food and drink as in a restaurant.*<sup>248</sup>

Just like a customer goes to a mandap-keeper for not just the quality of the food but for the services the same has to offer, one does not subscribe to a Cloud computing service because one wants to use a particular software but for the services the Cloud computing platform has to offer. If one wants a particular software one can purchase the software from a store and install it on to his computer—end of story. But having access to software on the Cloud is a part of the whole range of services a Cloud computing platform has to offer and it is these services that attract the clients to such platforms and not the software.

To take yet another example, one does not merely subscribe to the membership of a library because one wants to read books. One may rent or borrow a book, but one subscribes to a library because of the whole range of services a library has to offer. A library membership card represents access to the library and allows the holder of the card access to such services as per the agreement with the library. The situation can also be analogized to the purchase of a railway ticket that does not involve the sale of any goods but represents the right of the person to travel by railway.<sup>249</sup> It is similar, for example, to purchase a ticket to watch a movie in a cinema.<sup>250</sup>

And as to the first point (*i.e.*, taking undue liberties with legal fictions under Article 366(29A)), one must note *BSNL*. The opinion in this case was delivered in 2006 by a unanimous three-judge bench of the Supreme Court. The question before the Court was regarding “the nature of the transactions [of] mobile phone connections . . . . Is it a sale or is it a service or it is both?”<sup>251</sup> The State Sales Tax authorities of the State of Kerala had levied sales

<sup>248</sup> *Kalyana Mandapam*, (2004) 5 S.C.C. at 651 (emphasis added).

<sup>249</sup> See *Sunrise Associates*, (2006) 5 S.C.C. at 621-22 (“The sale of ticket does not necessarily involve the sale of goods. For example, the purchase of a railway ticket gives the right to a person to travel by railway . . . *The actual ticket is merely evidence of the right to travel.*” (emphasis added)).

<sup>250</sup> *Id.* at 622.

<sup>251</sup> *BSNL*, (2006) 3 S.C.C. at 16.

tax on “the value of activation charges in the sale price of a SIM” (Subscriber Identification Module) Card whereas the Service Tax Authorities had levied service tax on the cost of the SIM Card.<sup>252</sup> The taxpayers resisted the levy of sales tax by contending that they were service providers under the Telegraph Act of 1885 licensed to provide telecommunication services and the legal fiction in Article 366(29A)(d) did not apply to the disputed transactions because “*there was no transfer of any legal right by the service providers nor any delivery of any goods which may be covered by the Telegraph Act.*”<sup>253</sup> Telecommunications being a service (and any contrary view being unsustainable), the nature of the service was such that it did not allow a transfer of a right to use goods.<sup>254</sup> The States, predictably, invoked the legal fiction under Article 366(29A)(d) to justify the levy of sales tax.<sup>255</sup> The scope of this legal fiction, States argued, could not be restricted because a transaction has been described as a service elsewhere.<sup>256</sup>

The Supreme Court rejected the States’ arguments and in an almost chastising tone observed that States cannot tax first and justify later.<sup>257</sup> In other words, the States cannot levy sales tax first then try to reverse engineer some kind of constitutional justification and expect the Court to approve of such levies. Article 366(29A)(d) does not give a blanket license to deem any transaction, beyond those that are mentioned therein, as that of sale.<sup>258</sup> One may remind oneself once again that the deeming fiction of Expl.-IV of the A.P. GST Act that was invoked to the transfer of the right to use software transferred *via* media that was upheld in the *Second TCS Case* found its underlying justification in Article 366(29A)(d). But reading *BSNL* and the *Second TCS*

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<sup>252</sup> *Id.* at 17.

<sup>253</sup> *Id.* at 22 (emphasis added).

<sup>254</sup> *Id.* at 23 (“It is pointed out that none of the State could contend that telecommunication was not a service. It was submitted that the service did not allow for transfer of right to use goods...the SIM card was merely an identification device for granting access and was a means to access services.”).

<sup>255</sup> *Id.* at 24 (“It has been argued on behalf of the State of Uttar Pradesh that . . . [i]n granting permission to the service providers by the issue of licence, there was transfer of the right to use the telegraph which right was further given to the subscribers in a transaction which would be covered by Article 366(29-A)(d).”).

<sup>256</sup> *Id.* at 25 (“In any event, it is submitted, the meaning and scope of [Article 366(29A)(d)] cannot be limited on account of the fact that a transaction may have been described as a service in any legislative enactment or contract or licence.”).

<sup>257</sup> *Id.* at 30 (“Forty-Sixth Amendment does not give a licence . . . 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 . . . Transactions that are mutant sales are limited to the clauses of Article 366(29-A). 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.”).

<sup>258</sup> *Id.* (“Of all the different kinds of composite transactions the drafters of the Forty-Sixth Amendment chose three specific situations, a works contract, a hire-purchase and a catering contract to bring them within the fiction of a deemed sale. The first and third involve a kind of service and a sale at the same time. *Apart from these two where splitting of the service and supply has been constitutionally permitted in [Article 366(29A)(b) and (f)] there is no other service which has been permitted to be so split up.*” (emphasis added)).

Case together, it is submitted that any levy of sales tax on Cloud computing transactions would necessarily have to artificially declare that such transactions are sales. The only constitutional provision having language flexible enough to cover a legislative declaration so artificial would be Article 366(29A)(d). However, the scope of Article 366(29A)(d), as interpreted and explained in the light of the peculiar history that followed the 46th Amendment, in *BSNL* does not allow for such elasticity now.

Also, the *Second TCS Case* cannot be invoked to justify the levy of sales tax on Cloud computing transactions for three independent reasons—(1) because of the legal position that emerges on reading this case with *20th Century Finance*; (2) because of the constitutional limitations that emerge on reading this case with *BSNL*; and (3) the growing international consensus that Cloud computing transactions involve the rendering of services and not sales of goods (a point only highlighted and not deeply examined in this Article).

Before ending the Article, one may note two points, both coming out of reading *BSNL* with other Constitution Bench opinions that have been discussed above. First, *Second TCS Case* was decided by a five-judge bench and *BSNL* by a three-judge bench. *Second TCS Case* is therefore of a higher normative value and binding on the *BSNL* bench. The decision in *BSNL* was not given in ignorance of *Second TCS Case*. In fact, the *BSNL* bench noted *Second TCS Case* and observed that the approach as to what “goods” are as described in *Second TCS Case* was the “correct approach.”<sup>259</sup> That does not in any way dilute the arguments made in this Article. This is because even if the *Second TCS Case* was correct in saying that “‘goods’ may be a tangible property or an intangible one,”<sup>260</sup> the question as to whether or not there has been a sale is a question that exists independent of the question as to whether or not there are any goods.<sup>261</sup> This much, as shown above, has also been accepted by the *BSNL* bench and was accepted by the *Second TCS Case* bench as well.

Second, in the context of the limitations on levying sales tax on Cloud computing transactions deduced by reading *20th Century Finance* and the *Second TCS Case* together, the *BSNL* bench made important observations as well. The first was that *20th Century Finance* is not an authority for the proposition that delivery of possession is necessary for invoking Article 366(29A)(d).<sup>262</sup> But, “if the goods or what is claimed to be goods by the [Revenue] are not deliverable at all by the service providers to the subscribers, the question of the right to use those goods, would not arise.”<sup>263</sup> This Article has already shown that in a Cloud computing transaction a copy of the software is never actually delivered to the subscriber of the service.<sup>264</sup> In the context of

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<sup>259</sup> *Id.* at 33.

<sup>260</sup> *Second TCS Case*, (2005) 1 S.C.C. at 342.

<sup>261</sup> *See, e.g., BSNL*, (2006) 3 S.C.C. at 35.

<sup>262</sup> *Id.* at 37.

<sup>263</sup> *Id.* at 38.

<sup>264</sup> *Melanson, supra* note 222, at 890.

telephone connections, therefore, *BSNL* held that “providing access or telephone connection does not put the subscriber in possession of the electromagnetic waves any more than a toll collector puts a road or bridge into the possession of the toll payer by lifting a toll gate.”<sup>265</sup>

## V. Conclusion

The question of the imposition of excise duty on Cloud computing transaction does not arise because a sale of hardware is not involved in such a transaction. A Cloud computing transaction involves rendering a service for which a fee is charged. Such service may or may not include access to software on the Cloud. But no software is “manufactured” in this process so to attract duties of excise. The software, if “manufactured” at all in the excise sense of the term, is so manufactured outside the geographical territory of India, it therefore could not possibly be exigible to payment of any excise duties in India. This point, sounding rather elementary, is important to note because software is classified as excisable items under the excise statutes except that the rate of tax on software is “nil” or “zero.” Therefore, writing software is considered “manufacture” and thus exigible to excise duties, except that the rate of tax is zero and is therefore *practically, and not legally*, tax-free. If an item is not manufactured within the geographical territory of India, the question of applicability of excise duties to such an item would not arise.

So far as levy of sales tax by State Legislatures is concerned, levy of sales tax on a transfer of right to use software transferred via media (e.g., a CD-ROM) has already been upheld in the *Second TCS Case*. However, a Cloud computing transaction would not be covered by the *Second TCS Case*. Unlike the “sale” of software as it was transacted in the *Second TCS Case*, in a Cloud computing transaction there is no “sale” of software in that sense of the expression. The transfer of the intellectual property in the software, in the context of the *Second TCS Case*, is via media on which the software is stored. In such cases, the *Second TCS Case* held, the intellectual property has been *incorporated on a media* for the purpose of transfer. Sale is not just of the media, which by itself has very little value. In *Sunrise Associates*, a similar point is made in the context of lottery tickets. Further analogies include the sale of a railway ticket, sale of a cinema ticket, and subscription charges for a library. The central pillar of *Second TCS Case* is this incorporation of the software onto the media. This key distinction between a the use of intellectual property in the software on the Cloud versus the transfer of intellectual property in the software as it was in the *Second TCS Case* is a very important distinction that cannot be conveniently ignored. Especially in light of the fact that the Indian Supreme Court has not once rejected the dualism between software and the medium used to store, carry, and transmit the software.

If the software and the media used to store, carry, and transmit the software are two distinct things, and if the transfer of the right to use the software is

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<sup>265</sup> *BSNL*, (2006) 3 S.C.C. at 39.

exigible to sales tax by virtue of the transfer being via media, absent such media, the use of intellectual property in the software on the Cloud could not be said to be covered by the *Second TCS Case*. Thus, reading the *Second TCS Case* with *20th Century Finance*, the taxable event, in the case of Article 366(29A)(d), is the transfer of the right to use and if the transfer of the right to use the software is contingent on the presence of a media via which such transfer occurs, then in absence of such a media it cannot be said that a transfer of the right has actually occurred. If there is no transfer of right to use then the State Legislatures cannot levy sales tax on a Cloud computing transaction where the subscriber pays a fee to use the software on the Cloud.

The *Second TCS Case* cannot be invoked to justify the levy of sales tax on Cloud computing transactions because of the constitutional limitations that emerge on reading this case with *BSNL* and also because of the growing international consensus that Cloud computing transactions involve the rendering of services and not sales of goods. Reading *20th Century Finance*, the *Second TCS Case*, and *BSNL* together, the legal position that emerges goes very strongly against the levy of sales tax on Cloud computing transactions by invoking the legal fiction of Article 366(29A)(d). The legal fictions of Article 366(29A) were inserted into the Indian Constitution by the 46th Amendment. In all leading post-46th Amendment cases the meaning of the text of Article 366(29A) has always been understood and interpreted in light of the peculiar history that resulted in the 46th Amendment. This consistent mode of interpretation since the 46th Amendment was inserted does not allow for a deeming fiction of law to be created in order to treat a Cloud computing transaction as that of a sale in order to levy a sales tax under Entry 54 of the State List in Schedule Seven of the Indian Constitution. The State Legislatures would have to take undue liberties with the text of Article 366(29A), specifically with Article 366(29A)(d), create highly artificial legal fictions, and design outrageously reverse-engineered legal arguments to justify their constitutional competence to levy sales tax on Cloud computing transactions. The Indian Supreme Court has never been very tolerant of such practices.