KPMG

Tax Alert

Withholding Tax on purchase of software licenses

Background

This alert brings to your attention the High Court's judgment in the case of **Seven Seas Technologies Limited *(Taxpayer)* v Commissioner of Domestic Taxes (KRA)** [2021] KEHC 358 (KLR).

KRA carried out an audit on the Taxpayer and among the findings was that the Taxpayer was not withholding tax on payment to non-resident persons in respect of software licenses. KRA demanded **KES 21,525,013** comprised of **KES 15,320,673** for software meant for resale and **KES 6,204,340.67** for software purchased by the Taxpayer for its own use.

The Taxpayer objected to the findings. The KRA reviewed the objection and affirmed its position. The Taxpayer appealed to the Tax Appeals Tribunal (Tribunal). The Tribunal disallowed the appeal and affirmed KRA's assessment. The Taxpayer then appealed to the High Court.

The crux of the dispute at the High Court was whether Withholding Tax applies on payments for copyrighted material purchased by the Taxpayer. The relevant part of Section 2 of the Income Tax Act provides as follows:

"**Royalty"** means a payment made as a consideration for the use of or the right to use:

a) the copyright of a literary, artistic or scientific work; or

b) a cinematograph film, including film or tape for radio or television broadcasting; or

c) a patent, trademark, design or model, plan, formula or process; or

d) any industrial, commercial or scientific equipment.

The Taxpayer's grounds of appeal at the High Court

The Taxpayer challenged the Tribunal's decision on the following grounds:

i. The Tribunal erred in deciding that Withholding Tax applies on payments for copyrighted material;

ii. The Tribunal erred in concluding that the Taxpayer was commercially exploiting the copyright in the copyrighted item;

iii. The Tribunal failed to consider that payments for acquisition of copyrighted material do not fall within the definition of royalty hence Withholding Tax does not apply;

iv. The Taxpayer did not pay a royalty hence Section 35 of the ITA does not apply;

v. The Tribunal erred in failing to consider that the Taxpayer is a vendor of copyrighted material and in this regard does not receive any right to exploit the copyright; and

vi. The Tribunal failed to consider international best practice as set out in the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital;

Paragraph 8.2 of the commentary on Article 12 states that:

Where a payment is in consideration for the transfer of the full ownership of an element of property, the payment is not in consideration "for the use of or the right to use" that property and cannot therefore represent a royalty.

KRA's arguments

In rebutting the Taxpayer's arguments, the KRA contended that:

i. Payment for software was taken as a payment of royalty as it is consideration for the use and right to use copyright;

ii. The Taxpayer would not legally sell the software without authorization from the trademark owner. This authorization would only come upon a payment for a consideration for the right to use otherwise defined as royalties as per under Section 2 of the ITA;

iii. The contract for the software refers to a software sales agreement between Callidus Software Inc. and the Taxpayer;

iv. The software was reported in the balance sheet of the Taxpayer as an asset therefore was not purchased for resale as alleged by the Taxpayer;

v. The Withholding Tax was chargeable upon payment of the license fee as per Section 35 of the ITA and therefore Withholding Tax was due;

vi. The use of copyright does not necessarily mean reproduction or exploitation. The fact that the Taxpayer was using the intellectual property of another entity which is protected by a copyright then the payment thereof was a royalty as per the definition in the ITA; and

vii. Software is not a good neither is it a service but an intellectual property belonging to the inventor. The proceeds from sale of intellectual properties are royalties.

KRA urged the High Court to uphold the decision of the Tribunal and find that the Withholding Tax of **KES. 21,525,013.00** is due and payable by the Taxpayer.

Issue(s) for determination

From the parties' pleadings, the experts' evidence and written submissions, the High Court determined that the only issue for determination was whether Withholding Tax should be taxed on payments made for purchase of software and licenses and whether the payments amount to royalties or not.

The Court's findings

The High Court determined the matter in favour of the Taxpayer. In its decision, the Court observed that:

i. Copyright is transmittable by licence and payment of license fees as consideration of the right to use software falls within the definition of a royalty. However, an agreement would spell out the terms of any right to use or reproduce the copyright work;

ii. Annual subscriptions of licences do not confirm payment as royalty;

iii. KRA failed to prove that funds paid to Callidus Software Inc were royalty so as to attract Withholding Tax . The agreement between the software company and the Taxpayer was not provided to prove the terms of the license e.g. whether the license was transferable or restricted for software to be used internally only or for resale without transfer;

iv. The Tribunal erred in concluding that by buying and selling computer software, i.e. a copyrighted item, the Taxpayer was commercially exploiting the copyright in that copyrighted item;

v. The Tribunal had found that the Taxpayer was a distributor who purchased and resold the software without the right to tamper or modify it and this is not compatible with exploiting the copyright;

vi. The Taxpayer paid the license fee but did not acquire any partial rights in copyright and thus not subject to royalty as argued by KRA; and

vii. The OECD Model Tax Convention on Income and on Capital provides that where distributors are paying only for the acquisition of the software copies and do not exploit any right in the software this type of transaction should be dealt with as business profits and not as royalties.

The Court concluded that the Taxpayer was not subject to pay royalties and in turn not liable to pay Withholding Tax to KRA.

Our opinion

This is a welcome decision with respect to giving further clarity on the interpretation of royalties within the meaning of Section 2 of the Income Tax Act.

Notwithstanding the decision which was in favour of the taxpayer, businesses should assess their specific cases and contractual agreements to determine whether they are the users or distributors of copyright. Taxpayers should also evaluate whether the software agreements that they have allow them to modify the software or transfer certain rights to the software. The right to exploit the copyright (not the copyrighted material) falls within the definition of royalty subject to Withholding Tax.

KPMG is happy to assist on any issues arising from this decision.

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