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Withholding Tax on Royalties

The High Court rules that not all software-related payments are subject to withholding tax

The High Court of Kenya ("HC"), vide its judgement in the matter of **Seven Seas Technologies Limited** ("the Appellant") **v Commissioner of Domestic Taxes** ("the Respondent") **Income Tax Appeal No. 8 of 2017** delivered on 10 December 2021 ("the Judgement"), overruled the decision of the Tax Appeals Tribunal ("TAT") in TAT Appeal No. 94 of 2015. The TAT, in its ruling, had determined that payments made by the Appellant to Callidus Software Incorporated ("CSI"), a non-resident software provider, with respect to software purchased for resale and own use constituted royalties and were therefore subject to withholding tax ("WHT") in Kenya in accordance with the provisions of the Income Tax Act ("ITA").

In the Judgement, the HC held a contrary view that payments made by the Appellant to CSI for the purchase of software do not amount to payments for the use of or the right to use any copyright of a literary, artistic or scientific work and therefore cannot be subjected to WHT in Kenya as royalties. Per the HC, payments for software will only constitute royalties, and therefore be subject to WHT in Kenya, where certain rights over the underlying software, inclusive of the right to reproduce, translate, adapt or modify are transferred to the purchaser.

In this alert, we discuss the salient arguments advanced by the Appellant and the Respondent and our view on the Judgement.

Background

The Appellant is a company engaged in the business of procuring and developing Enterprise Resource Planning ("ERP") software. After conducting an in-depth audit of the Appellant's tax affairs, the Respondent noted that the Appellant had not accounted for WHT on payments to Callidus Software Incorporated ("CSI"), a non-resident software provider, for the purchase of software. Specifically, the payments related to:

- Payments for software purchased for resale to third party customers; and
- Payments for software purchased for own use.

Per the Respondent, the above payments fall within the definition of 'royalties' as captured under Section 2 of the ITA and therefore should be subject to WHT in Kenya in accordance with Section 35 of the ITA. The Respondent proceeded to issue an assessment on unpaid WHT, which was confirmed after the Appellant unsuccessfully objected to the assessment.

Aggrieved by the Respondent's decision, the Appellant lodged an appeal to the TAT. However, the TAT dismissed the appeal on the basis that:

- Payments made for resale to end-user customers were in the nature of royalty and therefore subject to WHT; and
- The Appellant failed to demonstrate that they did not acquire the right to loan, sell or sub-license the software in relation to payments made for own use of software.

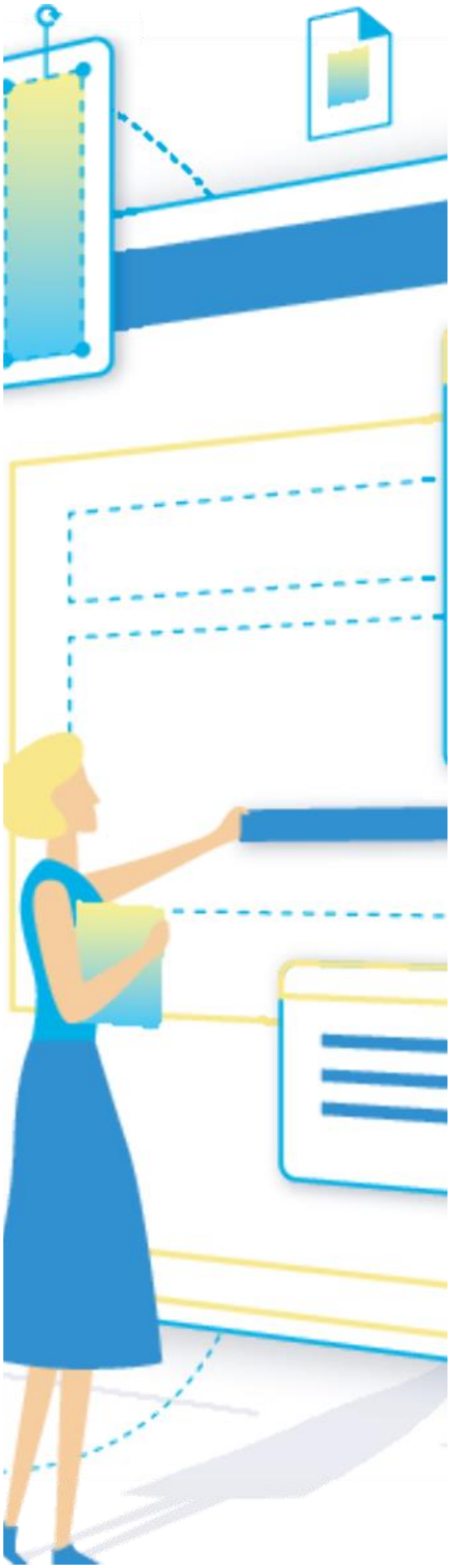
The TAT therefore held that these payments were deemed to be royalty payments and subject to WHT.

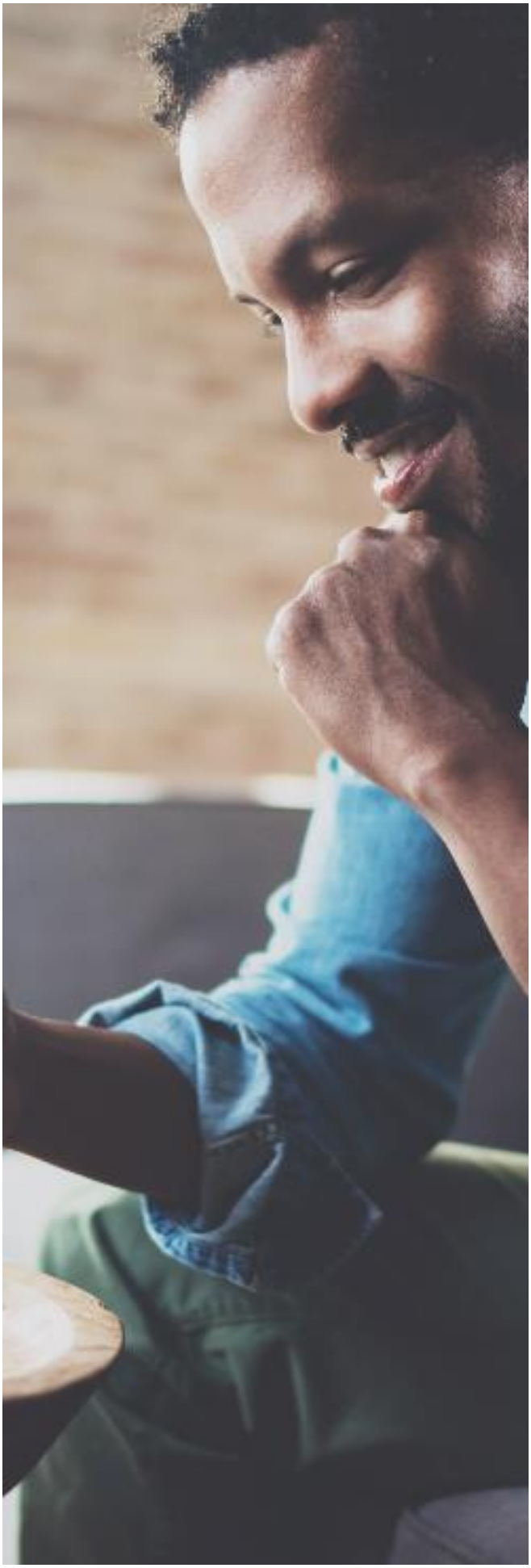
Further aggrieved by the determination of the TAT, the Appellant proffered an appeal before the HC.

Appellant's Case

The Appellant advanced the following arguments in support of its case:

- Payments for software should only be considered as 'royalties' if made in consideration for the use of, or the right to use, the underlying copyright in the program. Further, in determining whether a payment is a royalty, one must consider the distinction between the subject of the "copyright" and "copyrighted material". In the present instance, the Appellant purchased copyrighted material and not the use of or right to use the underlying copyright.
- Payments made by the Appellant to CSI were consideration for the purchase of copyrighted material and not the use of or right to use the underlying copyright. In support of this position, the Appellant relied on the definition of "computer program" in the Copyright Act, 2001. The definition implies that what is copyrightable is the set of instructions embedded in the program's code, not the medium in which the program is embedded.





- The Appellant further relied on Section 26 (1) of the Copyright Act, which provides that the holder of a copyright has the exclusive right to control the reproduction, adaptation, distribution and broadcasting of the computer program.
- Per the Appellant, a payment can only constitute a royalty if it confers upon the purchaser rights in the underlying software inclusive of rights stipulated under Section 26 (1) of the Copyright Act. The Appellant submitted that the Software Purchase Agreement ("SPA") and End-User License Agreement concluded between it and CSI do not confer any intellectual property rights underpinning the copyrighted software and therefore the payments cannot be construed to be royalties.
- The Appellant made reference to the commentaries to Article 12 of the Organisation for Economic Cooperation and Development ("OECD") Model Tax Convention on Income and Capital ("MTC"), which provides that distributors only pay for the acquisition and distribution of software copies, not the right to reproduce or exploit the software itself.
- Accordingly, the Appellant concluded that the purchase of software, whether for resale or own use, did not confer any rights to reproduce or exploit the software itself. Rather, the purchase of software in the present instance involved the distribution and use of software copies, as opposed to the copyright itself, and therefore, payments made as consideration for the software do not amount to royalties.

Respondent's Case

The Respondent advanced the following arguments in rebuttal:

- Under Section 2 of the ITA, "royalty" is defined to include payments for the use of, or the right to use copyright in any works. Per the Respondent, the Appellant's ability to ***use*** the software for its own business and for resale, qualified the payments it made for the software as royalties.
- In addition, third party customers who purchased the software acquired the ***right to use*** the software when they purchased it from the Appellant. Accordingly, payments arising therefrom were also royalties and subject to WHT.
- The Respondent similarly relied on the SPA which granted the Appellant the right to use, resell and distribute the software, upon payment of a cost. Therefore, based on the SPA's terms, the Appellant did not just acquire rights to a "copy" of the copyright, it obtained actual rights embedded in the software. In their view therefore, the consideration paid under the SPA amounted to a royalty subject to WHT in Kenya.

- The Respondent further relied on the decision of the HC in ***Kenya Commercial Bank versus Kenya Revenue Authority [2008] eKLR***, wherein it was held that the definition of "royalty" in the ITA is wide to enable the Commissioner to collect WHT on both local and offshore transactions which could give rise to royalty payments.
- The Respondent also submitted that separating "copyright" from "copyrighted material" is unreasonable and only aimed at defeating the collection of WHT.

The High Court's Determination

The HC, in its analysis, determined the issues in dispute as follows:

- That a copyright is transmissible by license, and that payment of license fees as consideration for the right to use software ordinarily falls within the definition of a royalty. However, the agreement between the parties should indicate whether it confers any right to use or reproduce the copyright work or merely the right to access the copyrighted article.
- In the present case, the terms of the SPA did not specify the limitations of the license granted to the Appellant, hence it was not proven that the payments made thereunder were royalties subject to WHT.
- Further, annual license subscriptions paid by the Appellant do not suffice to confirm a payment as royalty, unless they are paid to the original creator of the asset, as held in ***Republic vs Commissioner of Income Tax & Anor [2005] eKLR.***
- The Court relied on international best practice as captured in the commentaries to Article 12 of the OECD MTC which confirms, under Paragraph 14.4, that payments made by a software distributor to a software provider to acquire and distribute software copies, without the right to reproduce the software do not amount to royalties for tax purposes.
- In that regard, the HC faulted the TAT for concluding that the Appellant was commercially exploiting the computer software by reselling it to third party customers, contrary to the OECD guidelines on software payments from distributors.
- The HC also relied on the Supreme Court of India's judgement in ***Engineering Analysis Centre for Excellence Private Ltd vs Commissioner of Income Tax Civil Appeals No. 8733-8734*** , wherein it was held that payments made to non-resident software providers through distribution and end-user license agreements could not be construed as being royalty payments.
- In conclusion, the HC held that payments made by the Appellant to CSI do not constitute payments for the use of or the right to use copyrighted software and therefore do not fall within the ambit of royalties to the extent that the Appellant did not acquire any rights in the underlying copyright.

Conclusion and our View

The HC judgement is a welcome reprieve to taxpayers, as it clarifies the range of software-related payments which could be deemed as royalty payments and therefore subjected to WHT. By relying on the Copyright Act, 2001 to shed light on the scope of "copyright", the decision also attempts to cure the ambiguity inherent in the wide definition of the term "royalty" in the ITA.

Crucially, the judgement underscores the importance of parties to intellectual property-related agreements to ensure that the terms clearly delineate the rights conferred and any limitations thereto. The present case shows that in the event of future disputes, such agreements are the first point of reference, and as such, their drafting must be done with reasonable circumspection and certainty.

In addition, the decision has considered some critical aspects that might have been overlooked in the recent decisions and judgements that characterized payments made to various providers such as credit card companies as royalty payments. It will be interesting to see if this decision will influence future determinations on this characterization.

The Judgement also continues the trend evident in recent TAT and court decisions of relying on OECD conventions, guidelines and commentaries to provide clarity where local tax legislation is equivocal, or its interpretation is contentious. This trend signals a commitment to ensuring Kenya's alignment with international best practices.

The above notwithstanding, the KRA retains its right of appeal before the Court of Appeal ('CoA'). Should the KRA exercise this right, the CoA would conclusively weigh in on this matter. In the meantime, and in the absence of a decision to the contrary by the CoA, payments for the purchase of software, which do not involve the acquisition of rights in the underlying copyrighted software, do not constitute royalties and are therefore not subject to WHT in Kenya as such.

Should you wish to discuss this further, kindly feel free to contact any of the contacts below or your usual Deloitte contact who will be more than glad to offer you guidance and assistance.

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