

Withholding Tax Treatment of Payments for Software

Whereas the source of income for the payment of royalties generally applies to the use or right to use an intellectual property (“IP”), the provisions of the Tanzania Income Tax Act (“ITA”) may be construed to include one-off payments to acquire/purchase software within the scope of royalties and subject to withholding tax. In most cases, the Tanzania Revenue Authority (“TRA”) lifts the veil to apply withholding tax for the purchase of IP including software.

What is a royalty?

IP owners often outsource their intellectual property material to third parties for purposes of commercializing the product. To protect their rights in the intellectual property, owners must ensure that they receive adequate compensation for the external use of the material by third parties. The foregoing arrangement is vested in a licensing agreement that sets out the terms and conditions for the use of the intellectual property including royalty rates.

A royalty is defined by s. 3 of the ITA as any payment made by the lessee under a lease of intangible assets and includes the *use or right to use* intellectual property such as a copyright, patent, design, or trademark. Software being codified hence falls within the meaning of the term intellectual property. Royalties are paid periodically, either monthly, quarterly, or annually, and are calculated as the percentage of the net or gross revenue by the intellectual property.

In Tanzania, the TRA applies a 15% withholding tax on the purchase of software according to s.82 of the ITA. This position does not consider that the purchase of software does not entitle the purchaser to exploit the rights in the IP material.

Other jurisdictions

TRA's position may be juxtaposed to jurisdictions with varying tax positions on the same. In a recent appeal, (Kenya v Seven Seas Technologies Ltd., 2021), the High Court of Kenya had a detailed discussion that concluded that the sale of the copyrighted material does not attract withholding tax. In stark contrast to Tanzania's tax regime, the High Court of Kenya distinguished the sale of copyright material from the right to use or exploit copyrighted material, whereas only the latter is subject to withholding tax.

Kenya's position draws influence from international practice. The OECD Model Tax Convention on Income and on Capital concurs with Kenya's High Court position as it classifies transactions dealing with the acquisition or purchase of copyrighted material as business profit and not royalties subject to withholding tax.

Analysis

Tanzania's tax position, as explained above, is contentious due to the nature of the transaction vis a vis the definition of royalty. A transaction that involves the full transfer of intellectual property ownership of property should not constitute “use or right of use” as defined by the ITA. The right to use is a sub right from the purchase of the intellectual property. Royalties should only be considered for the use of an intellectual right which is the rationale behind the protection of copyrights.

The principle of exhaustion of rights may also be of relevance to guide this dissonance. The principle holds that once a copyright material is sold to a purchaser with the consent of the owner, the owner's intellectual property rights have been exhausted and he can no longer lay claim to the purchaser's authorised copy. The purchase of a copyrighted article as a singular asset rather than considering that the purchase entails a buy-in on the copyright itself. The two (2) must be distinguished for purposes of tax as realized gain from the purchase of transfer does not entitle the purchaser copyright ownership that must be captured by a royalty payment. In consideration of the same, the purchase of the material for purposes of founding an income establishment is a capital asset. Perhaps weight should be given to consider the difference between the purchase of software to realize an establishment and the use of software to continually generate income. This will aid in the assessment of whether the payment is a royalty payment for tax purposes.

In our opinion, TRA's position does not give weight to relative factors such as the nature of the payment. Other jurisdictions have successfully captured the trite principle of exhaustion of rights which alleviates the purchaser from a tax burden that was never theirs to carry in the first place.