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Intangibles and withholding tax

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In a taxable transaction, it is essential to first identify the parties to that transaction and, perhaps more importantly, the substance of the transaction. It may seem straightforward because people often transact in either tangible (goods) or intangible (services) items, but it is not normally the case from a tax perspective and more so in relation to intangibles in a withholding tax context. When referring to an intangible item, we are referring to an asset that lacks physical character (for example, patents, copyright, franchises, goodwill, trademarks, and trade names, as well as software). While intangible assets do not exist in physical form, tangible assets on the other hand denote items that do adopt a physical form (for example, inventory, equipment, machinery etc.).

Those who own either tangible or intangible items can enter into two transactions in relation to their assets. Through a typical willing seller/willing buyer sale transaction, owners can relinquish all their rights in relation to the particular asset and transfer ownership of that item to a third party. On the other hand, owners who do not wish to relinquish all their rights in relation to their assets may instead assign limited user rights to a third party in relation to the asset for a specified period of time after which rights extinguish and revert back to the owner. Indeed, this is the essence of leasing or rental agreements (in relation to tangible assets) and royalty and licence fees (in relation to intangible assets).

You will know it when you see it

Where one rents or leases out a tangible item, one expects to receive rent or lease payments while retaining ownership of the tangible item and that, once the term of the arrangement is over, the leasee will return the tangible item back to the lessor. The substance of such a transaction will be evidenced by the agreement that the parties to the transaction would have entered into; it is this agreement that will provide guidance on how to categorise the payments that are being made for tax purposes in the context of withholding tax. If, however, the agreement between the parties is a sale transaction, then different tax consequences that relate to sale transactions ought to follow.

For intangible items, the mirror transaction takes place where the owner of an intangible item, e.g. software, patents, copyright, franchises, goodwill, trademarks and trade names, assigns user or licence rights to a third party to use the intangible asset for a period of time in exchange for royalty payments. Here as well, the gist of the transaction will be evidenced by the agreement that the parties to the transaction enter into, and it ought to be the basis upon which any tax consequences in relation to that transaction follow. It also follows that if the substance of the agreement is a sale transaction, then the tax consequences that would ordinarily attach to a sale transaction should apply.

Recent decisions in East Africa

While the assignment of temporary user rights triggers withholding tax, an outright sale transaction should not. However, from reading recent decisions, one would be forgiven for arriving at the conclusion that it is not possible to purchase an intangible item and indeed, where one acquires an intangible item, one ought to pay withholding tax.

In Vodacom Tanzania Public Limited Company v. Commissioner General, Tanzania Revenue Authority, Court of Appeal of Tanzania at Dodoma, Civil Appeal No. 425 of 2020 (unreported), the dispute centred around the acquisition of exclusive software of licences for data transmission purposes. The Commissioner argued that the payments made by Vodacom in relation to the software licence were royalty in nature and therefore subject to withholding tax. On the other hand, Vodacom argued that, though the agreement was entitled 'software licence agreement', it was in actual fact a 'software purchase agreement' and as such not subject to withholding tax. In November 2021, the Court of Appeal in its decision indicated that the agreement at the heart of the transaction granted Vodacom a non-exclusive and non-transferable right to use the software; this was the hallmark of a royalty therefore held in favour of the Commissioner. The court relied on a number of precedents, including a case from Kenya, *Kenya Commercial Bank v. Kenya Revenue Authority*, [2016] eKLR, which seems to support the Commissioner's position.

However, in a more recent case, the High Court in Kenya in December 2021 seems to have a different position. In *Seven Seas Technologies Limited v. Commissioner of Domestic Taxes*, [2021] KEHC 358 KLR, the dispute centred around software that a taxpayer had purchased for resale, as well as software that it had acquired for its own use and the question was whether payments in relation to these were subject to withholding tax as royalty payments. In its decision, the court indicated that there was a distinction between payments made towards the purchase of copyrighted material (such as copyrighted software) and payments made to *acquire the right to use* copyright in a material (where one obtains limited rights in relation to the intangible). The former is not subject to withholding tax while the latter is as a royalty payment. After listening to information technology experts, the High Court concluded that the taxpayer in this case, who was a software distributor, was only a vendor of copyrighted material (the software) and it did not acquire the right to use the copyright in the said software. Consequently, no withholding tax was payable by the taxpayer on payments it made to purchase the software from the vendor. While the Tanzanian decision followed a couple of earlier Tanzanian Court of Appeal decisions as well as the *Kenya Commercial Bank* case, the High Court in its reasoning in *Sevens Seas* departed from holding in the *Kenya Commercial Bank* case.

Who needs to be vigilant?

We are aware that currently there are a number of tax disputes revolving around the acquisition of intangibles such as software and bandwidth where the Commissioner has maintained the position that the payments made in relation to their purchase ought to have been subject to withholding tax as royalty payments. In some of these, the tax dispute is self-inflicted due to the choice of words in their sale agreement. However, one should be able to decipher the intention of the parties from a deep-dive into the gist of the agreement – whether it was a sale transaction (which is not subject to withholding tax) or whether it was a user-right assignment (thereby yielding royalty payments which are subject to withholding tax).

It often happens that certain words and phrases when used in a particular context refer to something which everyone in that industry understands. However, when viewed from a different perspective, the same lexicon lends itself to varied interpretation which often does not reflect the intention of the parties from a tax and legal perspective. Therefore, if you are looking to acquire an intangible asset, you should ensure that the sale agreement reflects your intentions and, perhaps more importantly, that the choice of words used does not lend itself to varied interpretation.

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*If you have any questions regarding this article or if you would like to get in touch with our Tax team, please contact Joseph Thogo (**joseph.thogo@dentons.co.tz**) or your usual contact person at Dentons EALC East African Law Chambers.*

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