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GUIDELINES ON THE INTRODUCTION OF THE APPLICATION OF THE RIGHTS-BASED APPROACH FOR CHARACTERISING SOFTWARE PAYMENTS AND PAYMENTS TO NON-RESIDENTS FOR THE USE OF OR THE RIGHT TO USE INFORMATION AND DIGITISED GOODS AND THE APPLICABLE WITHHOLDING TAX TREATMENT

1. CITATION AND COMMENCEMENT

This instrument shall be cited as the **Guideline on the Introduction of the Rights-based Approach for Characterising Software Payments to Non-residents and Payments to Non-residents for the use of or the Right to use of Information and Digitised Goods and the Applicable Withholding Tax Treatmen**t in terms of Sections 2 and 32B and of the Income Tax Order of 1975 as amended (hereinafter referred to as the ITO).

2. PURPOSE

The guideline is meant to introduce the rights based approach to characterising software payments and payments made to non-residents for the use of or the right to use information and digitised goods and the applicable withholding tax treatment on such payments in order to promote voluntary compliance and to foster public confidence in the integrity and effectiveness of the taxation process.

3. THE LAW

I. The provision requiring the levying of tax on royalties and management charges paid to non-resident persons is contained in **Section 32B of the ITO**.

II. **Section 2** of the ITO (Definition Section) defines the term “royalty” to mean **any payment**, including a premium or like consideration, made for;

(a) *"the use of, or right of use, any patent, design, trademark, or copyright, or any model, pattern, plan, formula, or process, or any property or right of a similar nature; or*

(b) *the use of, or right to use –*

(i) any motion picture film; or

(ii) any video or audio material (stored on film, tape, disc, or other medium) for use in connection with television or radio broadcasting; or

(iii) any sound recording or advertising matter connected with material referred to in sub-paragraph (i) or (ii); or

(c) *the use of, or the right of use, or the receipt of, or right to receive, any video or audio material transmitted by satellite, cable, optic fibre, or similar technology for use in connection with television or radio broadcasting; or*

(d) *the imparting of, or the undertaking to impart, any scientific, technical, industrial, or commercial knowledge or information; or*

(e) *the rendering of, or the undertaking to render assistance ancillary to a matter referred to in paragraphs (a) to (d), or*

(f) *a total or partial forbearance with respect to a matter referred to in paragraphs (a) to (e)"*

III The 2017 **Commentary on Article 12, Paragraph (2) (Definition of Royalties)** of the *UN Model Tax Convention* describes the principles by which payments made to a non -resident as consideration for computer software, information and digitised goods may either be classified as royalties or otherwise.

4. CURRENT TAX TREATMENT

I. Currently, **all payments** for the use of software and payments to non-residents for the use of or the right to use Information and digitised goods are **classified as royalty payments** for tax purposes, with the exception being on royalties accruing to any ecclesiastical, charitable or educational institution of a public character, whether or not supported wholly or partly by grants from public revenue , this exception being provided for in Section 32B (1)(b)

II. Royalty payments made to non-resident persons are **deemed to be sourced in Eswatini** *under section* 32B (1)(*a*) of the ITO and payers are accordingly expected to withhold tax on such payments made to a non-resident person at the rate of 15%, or such reduced rate as provided under a tax treaty

5. RIGHTS BASED APPROACH FOR CHARECTIRISING SOFTWARE PAYMENTS

I The rights-based approach as prescribed recently (2017) in the UN Commentaries, characterises whether payments for the use of software, information or digitised goods are royalty payments based on the **nature of the rights** transferred in consideration for the payment This approach draws a distinction between the transfer of a "**copyright right**" and the transfer of a "**copyrighted article**" from the owner to the payer

A. Copyright right

A transaction involves a copyright right if the payer is allowed to **commercially exploit** the copyright. The term "*commercially exploit*" means to be able to

a) ***reproduce, modify*** *or* ***adapt*** *and* ***distribute*** *the software, information or digitised goods; or*
b) ***prepare derivative works*** *based on the copyrighted software, information or digitised goods for distribution.*

Generally, the payer is granted acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) for the use of the software, information or digitised goods in a manner (i e. to **exploit the rights** that would otherwise be **the sole privilege of the copyright holder**) that will, without such granting of use, **constitute an infringement of the copyright**.

In such instances therefore, the payments are for the "right to use the copyright in the program" that would otherwise be the sole prerogative of the copyright holder

B. Copyrighted article

A copyrighted article on the other hand is transferred if the **rights are limited** to those necessary to **enable the payer to operate the software**, or to use the information or digitised goods, for **personal consumption** or for use **within his business operations**

In many instances, the user is **provided with a copy** of the product, which is downloaded to a device for use Any right obtained to enable the **end-user to copy the digital signal** onto a media is incidental to the process in which the content is captured and stored and **does not constitute a transfer of the copyright right.**

In some cases, a payer may obtain **multiple rights in one payment** In determining whether a payment is for the right to use a copyrighted article or a copyright right, the **primary purpose of the payment** will be examined For example, where a customer downloads a book for **personal enjoyment**, the payment is primarily for the acquisition of a copyrighted article (i e. a copy of a book). To the **extent the act of copying** the digital signal onto the customer's device involves a **right to copy the content**, such a right is ancillary and incidental It **corresponds to what the payment is essentially in consideration for** (i e. payment for a copyrighted article).

Here, the rights transferred in these cases are specific to the nature of computer programs. They simply allow the transferee to copy the program, for example onto the user's computer hard drive.

6. TAX TREATMENT OF COPYRIGHT RIGHT VERSUS TAX TREATMENT OF COPYRIGHTED ARTICLE

i **Copyright right**

Where a payment is made to a copyright owner for the **transfer of partial rights in the copyright** as in the case of licensing of the copyright to be exploited by the payer, **the payment is a royalty** and therefore when such a payment is **made to a non-resident person**, it is **subject to withholding tax under Section 32B(1)(a)**

ii **Copyrighted article**

A payment for a copyrighted article on the other hand is not a royalty payment. Such payments made to a non-resident person will thus **not fall within the ambit of section 32B(1)(a) of the ITO** The non- resident person will not be taxable on such payments

7. EXAMPLES OF PAYMENTS FOR COPYRIGHT RIGHTS & COPYRIGHTED ARTICLES

i. <u>**Payments for software**</u>

(a) **By a distributor (without the right to reproduce copies of software**)

A distributor is granted the right to **distribute software** by the software or copyright owner but **does not have the right to reproduce** copies of the software Typically, the software is maintained in a server that is operated by the software or copyright owner. When the distributor makes a sale, he **provides the customer with a 'key'** for the customer to access and download the software directly from the software owner's server

(b) The distributor is not considered to be commercially exploiting the copyright rights in the software Accordingly, payments made by the distributor to the software or copyright owner are supposed to be treated as business income and is thus not liable to withholding tax. Business income received by a non-resident is subject to the Permanent Establishment test

ii. **By a distributor (with the right to reproduce copies of software)**

The software or copyright owner may arrange for the master files of the software to be **hosted on the distributor's server** Upon making a purchase, the customer downloads a copy of the software from the distributor's server In this case, the distributor is arguably **given the right to make copies of the software for distribution** The payments or part of the payments made by the distributor to the software or copyright owner **may constitute royalties**.

iii. **By end user**

(a) The end user **purchases a software** for personal/ company use The payment for which includes an **amount for maintenance and support services** incidental to the purchase of the software The full amount, including that amount for maintenance and support, is characterized as payments for a copy righted article *and thus fall outside of the ambit of Section 32B(1)(a).*

(b) The end user may make payments for additional services such as subsequent software maintenance and support services, user training, customization and development of add-on applications by building onto the existing basic software. These are not within the scope of application of the rights-based approach. Such payments for services will fall within the scope of section 59A of the ITO and be deemed to be sourced in Eswatini. Withholding tax on payments to non-resident persons may then apply.

iv. **<u>Payments for movie or film</u>**

(a) Payment made to acquire a copy of a movie or film, say through a download or on some magnetic media, is treated as payment for a copyrighted article if the payer is **not given the right to commercially exploit the movie or film** Generally, the payer **acquires a copy of the movie** for his private viewing and enjoyment He is **not allowed to screen the movie publicly**, or to **re-distribute the movie** This

transaction will not be subject to withholding tax as it is a transfer of copyrighted article

(b) On the other hand, if the payer is a **cinema operator or an airline entity** that acquires the movie for **screening to its customers**, the payment to the non-resident **is a royalty** for the use of the **copyright right in the movie** and is subject to withholding tax

v. **<u>Payments for information (i.e. subscription payments to information providers such as Bloomberg or Lexis-Nexis)</u>**

(a) Banks and research houses **may pay information providers** for information in order for them to service their customers. Generally, such payments allow the analysts to **make use of information** to support their work or generate reports for customers.

(b) The use of information is generally **not considered to be commercial exploitation** of the information if its use is to **support the work done by the analyst** and not a mere reproduction or onward distribution of the information This means that the **usage of information** is **limited both qualitatively and quantitatively**. Such payments are considered as **payments for copyrighted articles**.

8. CONCLUSION AND SUMMARY

I Notwithstanding any provision in the ITO, the rights based approach in classifying payments made to non-residents for software and payments for the use of or the right to use information and digitized goods should be applied when deciding whether or not a particular payment should be subjected to a withholding tax charge in terms of Section 32B of the ITO

II. In the event further clarity is needed on the application of the rights-based approach on a particular transaction, a ruling on that particular payment may be requested from the Commissioner General.

III. The misclassification of a payment as a payment for a copyrighted article and thus not liable to the levying of withholding tax, will not absolve any person from any liability for failure to withhold or remit (timeously) contained in the ITO.

APPROVED

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Commissioner DT