

Taxing Computer Software Royalties in Kenya: Reconciling Conceptual Approaches through Copyright and Property Law

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ABSTRACT

Kenya has recently witnessed litigation regarding the tax implications of acquired software. Simply phrased, if software is intellectual property, then the usual tax implications attached to intellectual property will obtain. Though intuitive, this position is not as straightforward when it comes to acquisition of computer software. One main reason is responsible for the difficulty—the anatomy of computer software. This anatomy forces a more nuanced analysis of the components of a software transaction, and specifically the nature of interest in question. A corollary is that a diverse range of transactions—all involving different and separate interests—are possible. A proper taxation regime requires clarity as to what subject matter is subject to the tax treatment, be it a sale, licence, gift, and so on. The diversity of transactions possible regarding a single copyrighted work, however, anticipate the possibility of varied subject matter, specifically for tax purposes, which possibility diminishes any immediate certainty of the subject matter involved. Therefore, if it is possible for various kinds of

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market transactions, all with different tax implications, to inhere with respect to a single work of software, a more deliberate view is required. Kenyan jurisprudence has appeared to accept a broad characterisation of software-related transactions as attracting royalty payments.

Recognising the obvious conceptual error in this view, other jurisdictions have drawn a clearer line between “copyright” itself and “copyright-embodiment” articles. Fundamentally antithetical tax obligations accordingly accompany this differentiation.

Keywords: Computer Software, Intellectual Property (IP), Personal Property, Royalties, Tax Law

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1. INTRODUCTION

An assignment is the transfer of ownership in copyright where the assignee becomes entitled to deal with the copyright in a manner synonymous with the owner (Bently & Sherman, 2014) although subject to the owner’s moral rights (Copyright Act 2001, 2021).¹ Usually, the consideration for an assignment is payment of royalties. Unlike an assignment, no proprietary interest is passed

¹ See Section 32, Copyright Act, No. 12 of 2001. There general provision is that moral rights are retained independently of an author’s economic rights and even after the transfer of such rights.

Journal of Intellectual Property and Information Technology Law (JIPIT) under a licence. (Bently & Sherman, 2014). A licensee is merely permitted to do those acts with respect to the copyright which would amount to infringement were it not for the licence (Copyright Act 2001, 2021). Such a permission may extend to some or all the rights.

Payments in respect of licences and assignments are considered royalties. A royalty “allocates the risk of market or commercial failure and the advantages of market success of the licensed subject matter” and shapes the “economic incentives or disincentives that the licensee has in using the subject matter...” (Nimmer R, 2014, p. 523). In relation to intellectual property (IP), “royalties” refer to the fees due to an owner by an assignee or a licensee, in whichever way the payment plan is structured, by instalments or as a lump sum (*Rohmer et ux. v. Commissioner of Internal Revenue*, 1946).

Section 34(2) of the Income Tax Act provides that “tax upon the income of a non-resident person not having a permanent establishment in Kenya which, inter alia, consists of management or professional fees, a royalty or interest shall be charged at the appropriate non-resident rate in force at the date of payment of that income” (Income Tax Act 2012, 2021). Section 2 of the same Act defines royalty as:

[a] payment, made as a consideration for the use of or the right to use, among other things, the copyright of a literary, artistic or scientific work, as well as any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific equipment or experience, and gains derived from the sale or exchange of any right or property giving rise to that royalty. (Income Tax Act 2012, 2021).

The difficulty with the blanket application of this section to software transactions is that it seems to primarily contemplate transactions in rights of Copyright itself. This becomes clear as an unstable view upon a consideration of the various IP and common law concepts applicable to such transactions.

This article is divided into six parts. Part 1 gives the introduction, highlighting the present jurisprudence on the

taxation of software royalties in Kenya. It also discloses the underlying issues that this jurisprudence is yet to respond to, thus introducing the key questions that the article seeks to answer after laying out the legal problem. Part 2 defines and distinguishes the various market transactions that could inhere in a single copyright work: licences, assignments, and sales in the case of physical media. It analyses the nature of royalties and how they are implicated, if at all, in each of the identified market transactions. The part also reviews the landmark Kenyan jurisprudence on the subject in a bid to highlight the legal problem. The review finds that there is no discernible recognition of the legal dichotomy between copyright and copyright articles.

Part 3 introduces the conceptual legal tools that may be utilised in laying down a more nuanced approach to the taxation of computer software especially that which is embedded in physical media. This proceeds from the realisation that the present state of jurisprudence on the subject in Kenya is wanting. Specifically, the employment of these tools furthers a nuanced understanding of the legal distinction between copyright and copyright articles. Part 4 delves into the question of ownership and seeks to find a coherent doctrine of ownership in the context of the unilateral measures taken by copyright owners to exclude ownership for transferees of software products. It is discovered that these exclusions face many practical and theoretical uncertainties, which reality poses a difficulty for taxation laws, which laws generally require clarity of taxable subject matter. Part 5 discusses the implications of the earlier discussions on the taxation regime, which implications will, ideally, be the main considerations for formulation of software taxation policy, as well as a guide to Kenyan courts navigating the jurisprudence on the matter. Part 6 concludes the discussion.

2. THE CONSENSUS ON SOFTWARE ROYALTIES

The law treats copyright as personal property that can be exploited in a number of ways, most importantly by assignment or licence (Bently & Sherman, 2014). Resultantly, copyright can be

Journal of Intellectual Property and Information Technology Law (JIPIT) transferred to those who can exploit it more profitably (Bently & Sherman, 2014). In the event that a transaction is an assignment or licence, the income derived is considered to be royalties, and it is in this way that the issue of taxation is raised—royalties are subject to withholding taxes (WHT) (Income Tax Act 2012, 2021).

An important view taken by some jurisdictions is that when the right to use or exploit copyright is given by an owner to another instead of an outright sale, then the consideration paid for such is what can properly be termed as royalties. Kenya's jurisprudence appears to propose that generally, payments respecting IP are royalties. These two views are fundamentally antithetical. In *Kenya Commercial Bank v Kenya Revenue Authority*, the issue was whether royalty payments for a licence were subject to (WHT *Kenya Commercial Bank v Kenya Revenue Authority*, 2016). Kenya Commercial Bank (KCB) had entered into a Software Licence and Service Agreement with an Indian company, Infosys Technologies Limited, by which KCB was to receive banking software packages and attendant professional services. Following a later review of the contract and the project, the bank and Infosys agreed to terminate the original agreement. The bank was required to pay Infosys the sum of 353,565 US Dollars (USD) as outstanding fees for the licence, services, annual technical support, and travel expenses for the implementation of the software packages. The bank was assessed as liable to pay WHT on Infosys payments, interest and incidental expenses on Nostro accounts, and an audit fee paid by the bank to Ernst and Young. On appeal, the Local Tax Committee held, *inter alia*, that the payment to the foreign company was in respect of royalty under the Income Tax Act and was therefore subject to WHT.

The appellant's position was that since Infosys did not deliver the software, and since the contract was ultimately terminated, the payments were deposits which were treated in its accounts as capital-work in progress and not payment for services rendered. Further, the appellant contended that deposits do not attract WHT. The respondent's position was that from the invoices, the payments were instalments in respect of licence fees. The High Court held

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that payments to Infosys were for the licence to use software packages and for professional services which amounted to income for Infosys for which WHT was payable.

The Court of Appeal reasoned that whether payment was for licence and related services or deposits is a question of fact to be determined from the agreement and the transactions between the parties. That question of fact had been determined by the Commissioner, the Income Tax Local Committee and by the High Court. The three entities made a finding that the payments were for licence fees and related services and not deposits for capital-work in progress. The agreement did not provide for payment of deposits. It provided for payment of licence specifically.

On appeal, the Court of Appeal noted that the agreement in question was for grant of a licence to the bank for use of a software program. There was a specific clause to the effect that all title, copyright and other proprietary rights would be retained by the licensing company, and that all received software not paid for in full would be deleted or destroyed. It was the court's holding therefore that this was categorically a licence in respect of which the licence fees were "royalties" for tax purposes.

This passage is illustrative of what may be considered to be the rule deferred to by Kenyan courts on the issue of taxing computer software: if software is IP, then payments with respect to it are royalties, and WHT are therefore due for all related payments.

The question at hand was considered more proximately in the case of (*Seven Seas Technologies Limited v. Commissioner of Domestic Taxes*, 2015). The case, which is, at the time of writing, pending appeal from the Tax Appeals Tribunal (TAT) to the High Court, involves a software distributor engaged in the purchase of computer software, primarily in physical media, from a foreign company and subsequent resale of such software to local entities. Responding to the question whether the payments were to be subjected to WHT, the TAT found that the company failed to withhold taxes in what the TAT considered to be royalties for computer software licences. The tax authority's contentions were,

Journal of Intellectual Property and Information Technology Law (JIPIT) firstly, that the use of another entity's IP by the appellant then made payment thereof a royalty. Secondly, that software, being IP, is neither a good nor a service. Therefore, it can only be sold by the sale of the right by the author/developer (Respondent's Statement of Facts, personal documentation, March 3, 2017). In sum, KRA's position was that as a rule, proceeds from the sale of IP are royalties. In response, Seven Seas submitted that it could not be considered the user of a copyright but was rather merely a vendor without any right to exploit the copyright as a licensee would have, for instance. Seven Seas contended further that payments made to acquire and distribute copies of software, without the right to reproduce such software, can only be considered revenue for the sale of software as opposed to royalty payments (Applicant's Submissions, personal documentation, November 19, 2018).

Presently, the key issue facing the High Court in this appeal is whether the purchase of software by a distributor/seller should be treated as a royalty payment to the owner, or simply a purchase of a product bearing in mind that the distributor is not the end-user and does not receive rights of exploitation.²

These two cases, when juxtaposed, illustrate the complexity that arises from the taxation of royalties. In the KCB case, there was a clear instance of a licensee tendering payments to a licensor for computer software. Going by the Section 2 of the Income Tax Act, WHT was payable for the use of software as IP since the payments were royalties. However, in the Seven Seas case, the matter was not as straightforward. The company which KRA found liable to pay WHT was a purchaser and reseller of software. In the course of its business, it did not engage either in the use, or acquisition of, copyright in the software. Its role is to merely purchase and resell such software. This raises the question as to whether it should be accorded different legal treatment, especially considering that even in such a case, the software is usually supplied under a standard licence agreement. The question addressed in this article is whether such a purchaser should be

² Written Submissions have been filed by the appellant addressing this issue as per the court's direction, on 4th August 2020.

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considered a licensee of IP rights—therefore a payer of royalties for tax purposes—or a business regularly dealing in software subject to income tax.

3. SOFTWARE TRANSACTIONS NOT INVOLVING THE RIGHT TO USE: SOME CONCEPTUAL TOOLS

As established, there is a general understanding that royalties are payable for the use of, or the acquisition of rights over, copyright. It is therefore necessary to distinguish between instances when such a right is transferred (acquired) in commercial transactions, and those in which it is not. Kenyan courts have not considered this question. This part proposes several conceptual tools necessary to understand potential solutions to the issue discussed in this article.

3.1. Personal Property and Sale of Goods

Assignments and licences are the usual avenues through which an owner may exploit their exclusive rights. Without a transfer of any rights to use or reproduce the work, there cannot be a licence or assignment. At the same time, the subject matter over which copyright accrues, is treated as personal property which owners can also transact. Bently and Sherman (2014) noted that there are various reasons why the law would treat copyright as a form of personal property. It is this notion that allows the possibility of the sale of a chattel embedding copyright, meaning that a copyright work is not limited to assignments and licences with regard to its exploitation. For example, one may think of a sale of articles embodying copyright—a book for instance. Such a sale does not confer any of the owner’s exclusive rights (Bently & Sherman, 2014)³ beyond the right of private use by the buyer—

³ The copyright owner’s exclusive rights are the following: the right to copy the work; to reproduce the work; to issue copies of the work to the public; to perform the work publicly; to broadcast the work; to make an adaptation of the work; and to authorise any of the above. See Bently & Sherman, 2014, p. 140-176.

Journal of Intellectual Property and Information Technology Law (JIPIT) reading (Asay, 2013).⁴ This distinction between transacting in the rights and in the copyrighted material is only possible where copyright subject matter, whatever its form, is legally understood as physical choses in possession—personal property. With this dichotomy in mind, an assignment of copyright can be viewed as “a distinct legal transaction not affected by mere sale or transfer of the work itself” (Bently & Sherman, 2014).

There is considerable consensus on the idea that software in a medium should be treated as both copyright as intangible personal property (choses in action) and tangible personal property (choses in possession). This can be viewed as a third category of possible software transactions, the other two being assignments and licences. As (Nimmer, 2014, p. 275) noted:

Another common form of conditional transaction involves an unconditional sale of a copy of a copyrighted work or a patented machine. In each case, while the buyer is the owner of the copy or machine, many uses of it or of the contents are restricted by copyright, patent or other IP rights...

Kenya’s jurisprudence only seems to recognise software transactions as implicating either an assignment or a licence.

In order to hold that there has been a “sale” at law, it is necessary to demonstrate that the subject matter was “goods” for that purpose (Sale of Goods Act 1930, 2021). With specific regard to software, common law courts in India have reasoned that the test to ascertain whether some subject matter is “goods” for the purposes of sales tax—not WHT on royalties—is not merely whether the property is tangible or intangible or incorporeal. Instead, the test is whether the concerned item is capable of abstraction, consumption and use, and whether it can be transmitted, transferred, delivered, stored, possessed, etc (*Tata Consultancy Services v. State of Andhra Pradesh*, 2004). In the case of software, all of these are possible, because once IP is put on a medium, it becomes goods (*Tata Consultancy Services v. State of*

⁴ This is usually a default entitlement, covering personal non-commercial use. See, generally, Asay, 2013.

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Andhra Pradesh, 2004). Thus, for the purposes of sales tax, the term “goods” cannot be assigned a narrow meaning (*Tata Consultancy Services v. State of Andhra Pradesh*, 2004). This test creates what has come to be referred to as the copyright and copyright article dichotomy colloquially.

When considering IP as personal property, the conceptual step being taken is the distinction between the IP interest as a chose in action on the one hand, and the article bearing such IP as a chose in possession on the other. Bently and Sherman (2014) observed:

Thus if a person sells an original painting or manuscript, this (of itself) transfers only the personal property right in the chattel; the copyright remains with its owner. If a vendor wishes to transfer the copyright as well as the personal property in the chattel, this should be done explicitly (Copyright Act 2001, 2021).

At its logical conclusion, thinking of IP as personal property discloses that the variety of transactions possible with copyright cannot be limited to only assignments and licences.

A purchaser merely has domain over the copyrighted article and can only make use of such an article for the purpose it was bought for (internal use). The purchaser does not therefore have any rights to exploit the copyright in a similar manner as the owner. On the other hand, under a licence or assignment, a person is entitled to utilise the copyright subject matter in a manner which was otherwise protected by copyright law *i.e.*, to do what would otherwise be infringement. With the example of software in mind, once copies of software are marketed and distributed, such copies become “goods” which are subject to sales tax. This is also the case with other copyright subject matter.

Several factors may be important in ascertaining whether there is a sale of personal property tied to copyright, or whether there has instead been a licence or assignment (*Deputy Director of Income Tax (International Taxation and Others) v. Reliance Industries Ltd, and Others*). Indian jurisprudence has been particularly emphatic on this point (*Deputy Director of Income Tax (International Taxation and Others) v. Reliance Industries Ltd, and*

Journal of Intellectual Property and Information Technology Law (JIPIT) *Others*).⁵ Usually, the considerations to be made include whether the purchaser obtained the right to copy, reproduce, or make use of the article in a manner other than onward sale or personal use, and received economic rights transferred by the original owner. If these questions cannot be answered in the affirmative, then the finding of law must be that what was acquired was not a right in copyright, but rather an article within which copyright inhered. The transaction, thus, being neither a licence nor an assignment, becomes a sale. Considering that sales of goods do not generally attract royalty payments, taxes on royalties do not become payable with respect to such a transaction.

There is also a view that assignments should not attract royalty payments as pronounced in *General Aniline & Film Corp. v Commissioner*. In that case, transfer of the entire patent interest was deemed to be a sale, and therefore the proceeds could not be taxable as royalties. However, this is a marginal view and does not seem to be reconcilable with the position in the Kenyan Income Tax Act as outlined earlier. Ultimately, an assignment is a transfer of the economic rights in copyright, and this qualifies to be considered as an “acquired” right for royalty purposes.

3.2. *The First Sale Doctrine*

An important task for IP law is to make the market aware of what benefits, in property law, an owner of a copy (or a machine) has, and about when those benefits apply. One such benefit is the right to distribute or sell that copy or, say, that machine without seeking the permission of the rights owner (Nimmer, 2014). Just like personal property (and the nature of copyright as personal property has been noted above), it is possible for the owner of an article bearing a protected interest, such as a compact disc containing copyrighted expression, to alienate the machine itself through a disposition of it under a sale.

⁵ There is a litany of Indian precedent on this point. See, for instance, *Deputy Director of Income Tax (International Taxation and Others) vs Reliance Industries Ltd, and Others*.

The rule above has, academically, been referred to as the “first sale doctrine.” It is to the effect that the rightful owner of a copyrighted work has the right to sell that copy, but nothing more. Thus, the owner of the article (or any person authorised by such owner), is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy. In this sense, the first sale doctrine becomes a “right” of the legitimate purchaser.

Software distributors usually make use of licensing arrangements rather than outright sales. By licensing the use of software rather than selling a copy in the same manner that one sells a book, software developers can avoid the first sale doctrine’s consequences *i.e.*, purchasers will not be able to resell or dispose of the software (Hazen, 1985).

In order to ground the applicability of the first sale doctrine to contentious software copyright questions, it is important to understand the legal viewpoints relevant to the question whether software transactions should be considered “sales”. In the US, whether the sale of computer software is a sale of goods is unclear (Hazen, 1985). The usual finding by US courts is that software contracts calling for substantial amounts of service, such as the development of special applications programs, are not subject to sale of goods rules.⁶ By this logic, software contracts requiring little to no service or special skill by the supplier in view of the user’s needs would be deemed sales of goods. According to Hazen, the desirable approach is that transactions occurring as outright sales (perhaps with incidental services), should fall under sale of goods law (Hazen, 1985). However, by framing a transaction as a licence and not a sale, a software distributor can opt out of such sale of goods provisions. The most popular tool used for this purpose by software distributors/owners is shrink-wrap licences.

In the US case, (*DSC Communications Corp v. Pulse Communications*, 1999) the District Court found that the first sale doctrine protected the defendants from infringement claims

⁶ Section 2 of the Uniform Commercial Code provides for sale of goods law.

Journal of Intellectual Property and Information Technology Law (JIPIT) because they obtained the software in question after a lump sum payment and subsequently a right to possession of the software for an unlimited duration. On appeal, the appellate court found it important to determine the elements that constitute ownership of software. It noted that “ownership” is an imprecise term that is not defined in statute. It went ahead to determine factors that were relevant for what it termed would be a proper “characterisation of ownership”. It found that each of the agreements entered into limited the licensee’s right to transfer copies of the software or to disclose its details to third parties. Such a limitation, the court reasoned, was at odds with the first sale right to transfer copies to third parties. There was also a limitation against using the software on hardware other than that provided by the licensor. The court found that if the licensees were indeed owners of the copies, the law under Section 117⁷ would permit them to use the software on any hardware, not only that supplied by the licensor. Accordingly, the court found the acquirers of the software to be non-owners.

This decision has been criticised by academics. It has been argued that when a copy of a software program is transferred for a lump sum payment and for an unlimited duration (as was the case here and as affirmed by the trial court), the transferee should be considered an owner of that copy regardless of other limitations on their use of the software. In any event, property law in the common law tradition has always conceived of licences as being, *by definition*, for a limited term (Nimmer, 2014). Nonetheless, Nimmer (2014) has submitted that because ownership is a conglomeration of various rights, the fact that the right of possession is perpetual or obtained by a single payment, though relevant, is not dispositive as to ownership if the possessor’s right to use the software is heavily limited. The issue is further confounded by the court’s observation that in certain circumstances

⁷ This section of the US Copyright Act limits the copyright owner’s exclusive rights by allowing an owner of a copy of a computer program to reproduce or adapt the program if such an act is necessary for the program to be used in conjunction with a machine. Section 109, on the other hand, limits the copyright owner’s otherwise exclusive right of distribution.

a transferee could be both a licensee and the owner of a copy (Nimmer, 2014).

The *DSC* case is a perfect illustration of the general orientation of agreements that deem transferees of software to be licensees, and that intend—effectively—to obviate the legal possibility of such transferees being termed “owners”. Such a characterisation would immediately allow the acquirers to invoke the first sale doctrine. More importantly, if such acquirers are considered “owners” pursuant to a sale, then payments tendered by them cannot be considered royalties for tax purposes.

3.3. *Shrink-wrap Licences*

Shrink-wrap licences purport to bind the purchaser of computer software merely by the purchaser’s act of opening the package. These licences present a peculiar problem to the matter at hand. Specifically, they challenge the notion of “ownership” as conventionally understood in copyright. The legal reasoning underpinning such agreements is the idea that a copyright owner does not forfeit his right of distribution by entering into a licensing agreement (*Microsoft v. Harmony Computers & Electronics*, 1994). The difficulty is, however, that the purchaser of a copy of a computer program will presume themselves to be an “owner” of *that* copy, a notion which will often be reinforced by the first sale doctrine.

For there to be a consistent theory as to the taxation of copyright in software, there has to be a concrete understanding of the “ownership” interest by legitimate acquirers/transferees of software in view of both the personal property model and the first sale model. For the distinction between copyright and a “copyright article” to be maintained, the general orientation of shrink-wrap software as only conferring a “licence” as the transferred interest would have to be confronted. Already, offshoots of this critical view of shrink-wrap software are discernible in literature. Despite being

Journal of Intellectual Property and Information Technology Law (JIPIT) rather marginal (Nimmer, 2014),⁸ the reasoning behind these points of view is sensible. Essentially, shrink-wrap licences limit the usual rights acquired by a buyer of a copyright work. A key challenge of such licences is the obvious power imbalance in contracting. Such licences are drafted by the licensor (original owner of copyright) and are unilateral, hence of questionable enforceability (Hazen, 1985), particularly in the mass marketing context (Towle, 1999).⁹

Another legal issue with shrink-wrap licences is in the content of the terms themselves—they are largely what would be considered in common law to be “unconscionable” terms. Unconscionable in this sense is used to describe conduct that is “monstrously harsh” and “shocking to the conscience” (Black’s Law Dictionary, 1968). This is the body of common law otherwise termed the law of “unfair contract terms” (Elliot & Quinn, 2009). This branch of contract law concerns itself with instances in which contract terms are so manifestly unjust as to require the intervention of the legislature¹⁰ or the courts to avert an injustice. Because contractual terms are law, the question, then, would be: is this a desirable way to establish the law between the software supplier and the end user? A large part of the answer lies in answering the question whether the inability to negotiate has been considered as a benchmark for unenforceable contracts in Kenya. Is negotiation even a concern for courts in deciding on valid or enforceable contracts? This is exacerbated by the fact that retailers usually do not have the authority to alter the terms of a licensing agreement.

The body of Kenyan precedent has, to date, not addressed the question as to whether shrink-wrap terms are, by and large,

⁸ See Nimmer, 2014, commenting that such licenses are typically more likely to be upheld than not.

⁹ For an elaborate discussion of mass market IP transactions, see Towle, 1999, p. 121-178.

¹⁰ In the UK, this law is primarily organised around the Unfair Contract Terms Act of 1977 and the Unfair Terms in Consumer Contracts Regulations of 1999. This Act controls the use of clauses excluding or limiting liability for breach of contract, particularly when the wronged party is a consumer. The Regulations render ineffective certain unfair terms in contracts between sellers or suppliers and consumers.

unconscionable. However, the doctrine of unconscionable contracts is well established.¹¹ Extending this doctrine to shrink-wrap licences will require carrying over its essential purport—that unfair contract terms are not binding on the consumer (Elliot & Quinn, 2009). That said, the question of enforceability of shrink-wrap software has not quite been considered by Kenyan courts. The main reason, arguably, is that such software is usually accompanied by a dispute resolution clause which institutes arbitration as the preferred method. Such clauses typically provide that the procedural (*lex arbitrii*) and substantive law of the dispute resolution process will be that of the country, usually foreign, from which the software originates.

Most importantly, the law of contract formation raises a concern in relation to shrink-wrap licences. This is an important inquiry because it would enable courts to identify instances in which designations of transferees as non-owners, done by software developers, should be upheld. As (Hazen T, 1985, p. 146) asked, “should a transferor bind a transferee to the licence’s terms by virtue of the purchaser’s act of opening the software package”? In order for these questions to be answered by Kenyan courts, a preliminary consideration must be the modalities of the concept of ownership in such transactions.

4. NAVIGATING THE OWNERSHIP CONUNDRUM IN LICENSING LAW

4.1. *Ownership in Shrink-Wrap Licences*

There is a unique conception of “ownership” engendered, not only by shrink-wrap licences, but also other software agreements characterising transferees as licensees. The question of ownership is central to the proper nomenclature describing software transactions, and eventually for tax purposes. In the US, which is

¹¹ See, for instance, *Danson Muriuki Kihara v Johnson Kabungo* (2017) eKLR. In a contract for loan, the High Court observed:

“It is apparent from the authorities that a court of law will not interfere with contracts entered into by two consenting parties and the interest agreed upon unless the terms are on the face of it illegal, unconscionable, oppressive and fraudulent.”

Journal of Intellectual Property and Information Technology Law (JIPIT) the prominent originator of computer software and thus the seat of a large proportion of software litigation, there is jurisprudence dealing with this question. One important factor, unsurprisingly, is simply whether the copyright holder labels the agreement with the purchaser a licence agreement (Asay, 2013). Another factor is whether the copyright holder imposes important limitations on the recipient's ability to transfer the copyright work, as well as any other notable restrictions (Asay, 2013).¹²

(Asay C, 2013) has argued that courts err in focusing on the licensee/owner distinction, mainly because purchasers of copyrighted works are by definition licensees of the copyright. Sale of software generates a limited licence to use the work for personal benefit, subject to limitations such as fair use and, as would be expected, first sale rights (Asay, 2013). Asay noted:

Consequently, the strained legal analysis that focuses on determining whether someone is a licensee or an owner is a moot point. It has already been answered. It then becomes all the more illogical that a copyright holder, by designating purchasers as licensees and restricting them from transferring the work, can eliminate first-sale rights... (2013, p.19).

Preparatory documents to the US Copyright Act of 1976 reveals that Congress intended for first sale rights to limit copyright outright, and that this result ought not to be circumvented by semantics (Asay, 2013). Violations of conditions against future dispositions therefore become merely breaches of contract, and not of copyright. Despite this analysis, the challenge is that the US Act explicitly provides that first sale rights only apply to the owner of a copyrighted work. It would therefore seem mandatory that an owner/licensee analysis be made. A resolution of this issue could be a simple concession that, as (Asay, 2013) puts it, "for all intents and purposes purchasers of *copyright* works own

¹² These will generally include limiting uses to making one working and one backup copy of the copyrighted work; forbidding examination, disclosure, copying, modification, adaptation, and visual display; prohibiting duplication and third-party use; limiting use to a single computer; prohibiting multicomputer and multiuser arrangements; and permitting transfer to another computer no more than once every thirty days. See Asay, 2013.

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their copies of the work, regardless of what the licence agreement says” (emphasis added). The legal effect of such a concession should not be underestimated. It is an unequivocal acceptance of the copyright and copyright article dichotomy. Perhaps, and maybe even more controversially, it is an acceptance of the unenforceability of at least some aspects of shrink-wrap licences. (Nimmer, 2014).¹³ This is because, for logical consistency, such a purchaser must be allowed to exercise those rights ordinarily perceived as inhering in an owner at common law. This is so even if it would mean being at odds with some of the restrictions found in shrink-wrap licences, which cannot be thought of in any meaningful way as binding a true owner at common law.

4.2. *Ownership in other Licensing Agreements*

One might perhaps rightly observe that shrink-wrap transactions may not pose such a monumental hurdle to the copyright and copyright article dichotomy after all. It does not necessarily follow from licensing transactions that licensees are of necessity non-owners (Nimmer, 2014). This is important in the sense that it is conceivable that transferees who have been designated as licensees could be found, substantively, to be owners, negating any tax implications that would result from the former categorisation. In (*Mai Sys Corp v. Peak Computer Inc*, 1995), for instance, copies of copyrighted software were transferred to Peak as a licensee. Finding that Peak was not an owner of copies of the software for purposes of Section 117, the court held that it did not have the right to copy conferred on owners. Importantly, however, a criticism of this judgement has been that it fails to recognise the distinction between ownership of a copyright, which can be licensed, and ownership of copies of the copyrighted software (Nimmer, 2014). Simply Nimmer, “a party who purchases copies of software from the copyright owner can hold a licence under a

¹³ Purchasers are generally not expected to return the works, and in most cases, there is no expectation of recurring payments for continued access. The examples of non-ownership listed in the statute all envision only temporary possession of the work. See Nimmer, 2014, p. 279-282.

Journal of Intellectual Property and Information Technology Law (JIPIT) copyright while being an ‘owner of a copy for purposes of Section 117’” (2014, p. 279).¹⁴

Similarly, the Grand Chamber of the European Union Court of Justice (CJEU) has explored these issues in (*SAS Institute Inc v. World Programming Ltd*, 1995) which was a reference from the High Court of England and Wales. One of the key questions in that case was whether contractual provisions under a licence voided the claimed rights of the defendant. The defendant had lawfully purchased copies of the “learning edition” of the program in question, which were supplied under a “click-through” licence which required them to accept the attendant terms before being allowed to access the software. The terms restricted the licence to non-production purposes. According to the national court (which sided with the plaintiff), the defendant had used the various learning copies of the program to perform acts falling outside the scope of the licence (*SAS Institute Inc v. World Programming Ltd*, 1995).¹⁵ As does virtually every other sound copyright legislation, the EU Directive embodies what is called the idea-expression dichotomy, a rule that copyright does not protect ideas, but rather the expression of such ideas (*Faulu Kenya Deposit Taking Microfinance Ltd. v. Safaricom Ltd*, 2013).¹⁶ Based on this, the Grand Chamber went ahead to find that any contractual provisions violating this principle were null and void.

Put in perspective, the Grand Chamber’s position was emphatic on the idea that licensing provisions are not necessarily unassailable, in that they do not have to trump well-established principles of law. The court here subordinated contractual terms to the age-old copyright law doctrine of the idea-expression dichotomy. Which begs the question: are courts bold enough to subject shrink-wrap licences to the age-old common law

¹⁴ Fundamentally, it is a question of the extent of the restrictions set against a licensee, as seen in the DSC case, above at note. The *MAI* decision has nevertheless been defended since the obligations imposed upon the licensee were severe (although not as severe as in DSC), which fact has been used as justification for the decision.

¹⁵ *SAS Institute v World Programming Ltd*, Para 48. These acts included, importantly, reverse engineering for interoperability.

¹⁶ See Article 5(3) of the Directive. See also *Faulu Kenya Deposit Taking Microfinance Ltd. v Safaricom Ltd* (2013) eKLR.

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understanding of ownership further, which had as its pillar perpetual possession and transferability? If the logic by the Grand Chamber is to be followed, it is more likely that courts will find instances in which the restrictive terms of a software licence agreement do not warrant the refusal to characterise a licensee as an owner, if circumstances so demand.

4.3. *Common Law Perspectives on Ownership*

It would not come as a surprise to the reader that common law “ownership” is thought of as a superior unqualified status historically. An authoritative definition of an “owner” is, for these purposes:

He who has dominion of a thing, real or personal, corporeal or incorporeal, which he has a right to enjoy and do with as he pleases, even to spoil or destroy it, as far as the law permits... (Black’s Law Dictionary, 1968).

This view has however been subjected to criticism over decades of legal history. The key direction from which this view has been challenged has been the practical necessities and needs of the time (*Butler v. Frontier Telephone Co.*).¹⁷ It has been observed that ownership need not necessarily correspond to a sole despotic dominion for it to be legally valid as such, notably by Honore’s “bundle of rights” theory of property. (Honore, 1999) demonstrates that ownership constitutes of “incidents” of ownership, as opposed to absolute dominion. Of his eleven incidents of ownership,¹⁸ he notes that only three are necessary or essential in order to characterise one as an owner. These are the right to transfer, the right to possess and use, and the right to exclude. In a sense, the

¹⁷ Practical necessities of absolute ownership of real property, for instance, raised challenges in relation to oil and gas and mineral discoveries, as well as air traffic flight paths. See *Butler v Frontier Telephone Co.*, 186 N.Y. 486, 79 N.E. 716, 11 L.R.A., N.S., 920.

¹⁸ These incidents include the right to possess, the right to use, the right to manage, the right to the income of the thing, the right to the capital, the right to security, the rights or incidents of transmissibility and absence of term, the prohibition of harmful use, liability to execution, and the incident of residuality.

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purchaser of a copy of computer software appears to be entitled to all these.

If it is now settled that due to practical fetters, ownership cannot be properly considered to be absolute in the common law legal system, it becomes even more important to establish instances in which fewer incidents may be considered ownership, at least in a functional sense. The discussions above on shrink-wrap and other licences have brought one question to the fore: to what extent can the incidence of unlimited possession, and occasionally, transferability, lead to the categorisation of a licensee as an owner? Tate has conducted a thorough historical analysis of the common law concepts of ownership and possession, with the objective of determining the distinction between the two in a strict sense (Tate, 2006). The analysis seeks to find out whether the common law concepts of “right” and “seisin” correspond strictly to the Roman law distinction between “ownership” and “possession”. The former two were royal remedies for the recovery of real property based on whether they protected ownership or possession (Tate, 2006). Right (*ius*) and seisin (*seisina*) are compared here to the Roman law concepts of ownership (*proprietas*) and possession (*possessio*). Therefore, the controversy is whether right and seisin are synonyms for Roman ownership and possession.

Tate finds that original common law remedies in real property did not mirror the rigid distinction between ownership and possession (Tate, 2006). However, for Tate, this may not be the automatic position for what are termed “non-tenurial” remedies (which were a unique character of English land relations), and in some cases, closer resemblances to the Roman law typology may be found.¹⁹

Accordingly, there seems to be some evidence in common law history supporting the view that possession and ownership are not mutually exclusive. For our immediate purposes, a converse finding would render the characterisation of licensees as potential “owners” artificial at best, because the common law would already

¹⁹ This is mostly in the case of what are now termed “incorporeal hereditaments”, entitlements to land not involving actual ownership of such land.

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be clear that a possessor is always and by definition in a lesser stead than a true owner. Considering the evidence thus far, however, this is not necessarily the case. This notwithstanding, Honore's analysis is a clearer and, actually, more recent beacon.

5. TAX LAW AND SOFTWARE

It is a long-established principle that the taxation of an item demands clarity with regard to the subject matter in question. The High Court has repeatedly affirmed the rule that taxation laws must be clear of ambiguity and where there is ambiguity, the law should be interpreted in favour of the taxpayer and not the taxing authority (*Commissioner of Income Tax v. Westmont Power (K) Ltd*, 2002).

There is an array of British, Indian and American judicial precedents advancing the position that a sale qua sale of copyright articles does not attract the legal burden of royalty. The notable precedence emanating from Kenya's High Court and the TAT have addressed the tax implications of dealings by beneficiaries of copyright rights primarily. That is, entities that have acquired rights under an assignment or licence over computer software. By definition, the course of dealings by such entities have usually been characterised by the entities' distribution or reproduction of the copyright in a commercial sense.²⁰ This is a different question from that which attends a regular purchase of physical products that are copyright subject matter. In such cases, there is no exclusive right to reproduce that is acquired as a result of that transaction.

Because IP, once put on a medium, becomes goods, it has been argued that provisions dealing with, and defining royalties, cannot be made applicable to a situation of outright purchase and sale of a product. The transaction in question becomes "one of purchase and sale of a product and nothing more" (*The Commissioner of Income Tax v. Vinzas Solutions India Pvt Ltd*, 2019). The corollary

²⁰ Because even mere legal acquirers are permitted to use the copyright work, for personal use and to reproduce, either for creating back-up copies or sometimes for achieving interoperability through reverse engineering/decompilation.

Journal of Intellectual Property and Information Technology Law (JIPIT) of this observation is that if a sale of software in media is deemed to have occurred, then the first sale doctrine is automatically triggered. This operates as an automatic fetter to the right of the original copyright owner to distribute the copies upon such purchase. Therefore, the purchase of computer software can quite evidently, in some instances, be considered a sale of goods. As seen, there are good reasons for overlooking the artificial and sometimes counterintuitive casuistries of shrink-wrap licences on this point. The term “goods” includes chattels personal (personal property) and excludes choses in action and money (Sale of Goods Act 1930, 2021). Royalties cannot be applied to a case of outright sale of a product. This logic cannot prevail if taxing authorities are allowed to extend the ambit of “royalties” to entities that are merely involved in buying and selling software in the open market.

However, this article does not necessarily propose that a strict differentiation is made between a physical medium and the copyright work it carries as done in (*Tata Consultancy Services v. State of Andhra Pradesh*, 2004):

“Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media, *i.e.*, the paper or cassette or disc or CD.”

Instead, this article calls for a more nuanced understanding of the specific interests at play at any given instance in the elaborate web of software-related transactions. The Indian courts have in this regard taken a step in the right direction with the copyright and copyright article dichotomy. However, a more mature legal ecosystem on commercial dealings in IP will have to evolve and take into account the unique demands of software transactions under the broader subset of commercial transactions. This will mean drawing the contours between the service transaction and the sale transaction. Thus, despite sound doctrinal arguments being made in support of the dichotomy, it has been shown that merely using this tool can be conceptually weak. Nonetheless, the

present blindness of Kenyan courts to the conceptual dichotomy between copyright and copyright articles is precisely the lack of nuance that would create an environment of legal uncertainty for distributors of software in physical media in terms of their tax obligations. On this view, the rationale is that mere perpetual possession of a copyright article is not necessarily a dispositive factor in considering transferees to be owners, if there are other significant pre-emptive restrictions on their status as would-be owners. If such transferees are not thought of as owners, then the transaction they are involved in may not properly be characterised as a “sale”. If the transaction involved is therefore not a “sale”, and the transaction nevertheless entails a dealing in copyright, then the next best conclusion is that it is a licence, which would accordingly attract tax obligations under the head of royalties. However, it is a general rule of law that licences cannot entitle a licensee to exclusive and perpetual possession (*Street v. Mountford*, 1985; Cribbet & Johnson, 1989). These contradictions further underscore the need to disentangle IP commercial transactions from the complex web of sale of goods doctrine.²¹

Courts will also be called upon to clarify the status of parties to a software transaction. What is noteworthy, is that since there are convincing arguments for either position with regard to the transferee’s status, the final decision is ultimately a matter of jurisdictional preference. A key issue to be resolved is the status that transferees obtain upon mere purchase of software. The evidence of what is called here “mere purchase” is given, in summary, by demonstrating extensive restrictions on copying and utilising the copyright in the software (not the software itself) for commercial uses (*The Commissioner of Income Tax v. Ahmedabad Manufacturing and Calico Printing Mills Ltd*). Such restrictions clearly establish that the suppliers or original owners of the software were the sole and exclusive owner of the rights, title and property in the software. This situation is usually captured in agreements using the general term that copyright is not

²¹ For more on the general weaknesses of a sale of goods model, see Towle, 1999.

Journal of Intellectual Property and Information Technology Law (JIPIT) transferred (in whatever quantum). It is the status of such transferees, as owners or licensees, that Kenyan courts will be required to answer in order to assess the tax character of the transactions in question. It is already clear that there are sound arguments for either stand. In such an analysis, shrink-wrap licenses may not exactly demand a back-breaking assessment. As has been seen, these transactions already face the initial monumental challenges relating to validity *ab initio*. Negotiated agreements, however, pose a more serious challenge. In such agreements, courts must weigh the restrictions imposed upon the transferee against the contrasting rights obtained by them, to arrive at a sound characterisation of the transferee's status either as an owner or non-owner. In many cases, a heavily restrictive licence waters down the status of the transferee as a potential owner. A reasoned analysis of the applicable body of law on these issues is what will guarantee a consistent and sound system of rules on taxation of computer software.

6. CONCLUSIONS

This article has explored the conceptual issues underlying a policy decision to tax the broad range of software transactions as royalties. It has been shown that the prevailing view in Kenya is to characterise payments in software transactions, in general, as royalties attracting WHT. However, the article has established that a nuanced consideration of the copyright doctrine and property law renders this view unsustainable. Rather, more thoughtful approaches to the issue have been taken in Indian, American and, to some extent, European jurisprudence. A prominent view entails the distinction between copyright and a copyright article. Despite this, the article has observed that more complexities obtain for software transactions that demand a more detailed analysis, primarily in relation to the copyright and copyright article dichotomy.

Various conceptual tools have been recommended to address the problem. These are personal property theory, the first sale

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doctrine and shrink-wrap licenses. The former two concepts have been shown to support the copyright and copyright article dichotomy, while the latter tool seems to stand at odds with such a dichotomy. On this front, the contest between the contrasting views is very close.

The article has also explored the owner-licensee conundrum in software licenses and revealed that common law doctrines can be used to mount a substantive case for whichever preference is adopted by local courts. It is therefore a matter to be shaped by a country's specific tax and IP policy objectives. If the goal is to increase the tax incidents obtaining for dealers in software, then the view most consistent with this approach is that against the characterisation of licensees as owners, and that simultaneously recognises shrink-wrap licenses as valid and enforceable.

Ultimately, what is clear is that the present common law tools available, especially the law of sales, though applicable, exhibits a strenuous and tense relationship with the challenging nature of software as IP. The key lesson here is that a more responsive regime which, transcends old sales models and incorporates the novelty engendered by computer software law, has to be forged. This will include responding to the limits of the first sale doctrine as well as adopting a stable position on shrink-wrap licences.

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