REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
TAX APPEAL NO.94 OF 2015

SEVEN SEAS TECHNOLOGIES LIMITED.....APPELLANT

VERSUS

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND:-

1. The Appellant is a limited liability company incorporated in Kenya 15 years ago and is in the business of procuring and developing various Enterprise Resource Planning software solutions in partnership with global partners to deliver integrated business and technology solution to customers spanning the Healthcare, Homeland security and social services
2. The Respondent is established under Section 3 of the Kenya Revenue Authority Act Cap 469 and is mandated under Section 5 thereof to act as an agent of the Government of Kenya for the assessment, collection and receipt of revenue.
3. The Respondent conducted an in-depth audit of the Appellant for the period 2010 to 2013 and noted, inter alia, that the Appellant was not deducting Withholding Tax on payment to a non-resident persons in respect of software licenses procured and proceeded to raised additional assessment amounting to Kshs.30,813,332 as unpaid tax in withholding tax as well as corporation tax on interest expense that the respondent sought to restrict. The findings of the Audit and the Assessment of the taxes payable were formally

communicated to the Appellant vide the Respondent's letter dated the 30th day of October, 2014.

4. The Appellant objected to the aforesaid additional assessment of tax for Kshs.15,320,673/= being withholding tax on software procured for resale and Kshs.6,204,340.67/= on software purchased for own use in the business vide a letter dated the 28th day of November, 2014. The Respondent vide a letter dated the 16th day of January, 2015 confirmed the withholding tax assessment thereby prompting the Appellant to file the present Appeal before the Tax Appeals Tribunal.

THE APPEAL:-

5. This is an Appeal under Section 86(1) of the Income Tax Act, 1973, Cap 470 of the Laws of Kenya, filed by Seven Seas Technologies Limited disputing Withholding Tax assessment by the Commissioner of Domestic Taxes.

6. The Appeal by the Appellant against the Respondent's notice of confirmation of the additional tax assessment of Kshs.30,813,332/= was premised on the grounds set forth in the Memorandum of Appeal dated the 27th day of February, 2015 as reproduced hereunder:-

   i) That the Respondent erred in law and fact in their definition of the term royalty leading to an erroneous classification of purchase price for software as royalty payment.

   ii) That the Respondent erred in law and fact by constituting the consideration paid for software as payment for the use of copyright.

iii) That the Respondent erred in law and fact by classifying the consideration paid for purchase of software classified as software for resale and shrink-wrapped software as royalties in "APPENDICIES L and M" in this Appeal as royalties.

iv) That the Respondent erred in law and fact by disallowing interests expenses and restricting the deduction of interest in determination of the Appellant's taxable income for corporation tax purposes.

v) That the Respondent erred in assuming a nexus between the loan taken by the Appellant and the amount loaned to its sister companies.

vi) That the Respondent erred in law and facts by disallowing the expenses related to the interest income generated by the loan advanced by the Appellant to its UK sister company.

v) That The Respondent erred in law and fact by imposing interest restrictions on the amounts advanced by the Appellant to its subsidiaries for the business purpose of commercial expediency.

vi) The Appellant, in making payment of the amount of tax assessed by the Respondent, will be subjected to the form of inequitable hardship envisioned under Section 123(1)(b) of Income Tax Act.

7. During the hearing both the Appellant and the Respondent submitted that they would not be pursue grounds 4 to 8 as the issues on Corporation tax had been agreed upon. The only issue for determination in the Appeal by the Appellant is therefore only on withholding tax demanded amounting to Kshs.21,525,014/=

8. The Appellant in the Memorandum of Appeal prays for the Orders that the Respondent's confirmed assessment is fatally defective and

incurable and that the income tax demand is unlawful and should therefore be set aside.

THE RESPONSE:-

9. The Response by the Respondent was premised on the following:-

i) That the Appellant is a limited liability company registered in Kenya and carriers out the business of offering automated business solutions to corporate customers.

ii) The company was registered for an in-depth audit as per the Income Tax Act and the VAT Act in November 2013. Following a request by the taxpayer the commencement date was postponed to February 2014. Several meetings were held in 2014 where findings were presented, explanations given, documents availed and subsequently a demand issued on 30th October, 2014.

iii) Among the findings was that the company was not deducting, Withholding Tax (WHT) on payment to non-resident persons in respect of software licenses. The total WHT demanded thereon was Kshs.27,744,278/= although only Kshs.21,525,013/= is the subject of this Appeal as the taxpayer conceded to part of the liability.

iv) WHT on software which the taxpayer alleges was for resale was Kshs.15,320,673/= while WHT charged on software purchased for the taxpayer's own use in the business was Kshs.6,204,340.67 making the total WHT the subject of this Appeal Kshs.21,525,013/=.

v) The Appellant objected to the tax demand vide their letter dated 28th November, 2014. Following a review of the ground of objection and the arguments in support of the objection, KRA made a decision to affirm their position vide a letter dated 15th

December, 2014, leading to the filing of a Notice of Appeal dated 30th December, 2014 by the Appellant,

vi) A demand for Corporation Tax amounting to Kshs.2,348,469/= was also made on account of restriction of interest expense on the Appellant's borrowing owing to the fact that the Appellant had loaned out some monies to related companies without reciprocal income. Assessments for corporation tax had not been issued and the matter was therefore prematurely under appeal.

ISSUES FOR DETERMINATION:-

14. Having perused the Pleadings and heard the parties the issues for determination are:-

i) Whether payment for software license (as a vendor) for the purpose of resale to customers constitutes payment of a royalty.

ii) Whether payment for software licence for own in-business use without a right to make copies of the licence constitutes payment of royalties.

APPELLANT'S ARGUMENTS

15. The Appellant submitted that consideration made to acquire and distribute software copies is considered business profits as opposed to being in the nature of a royalty. The Appellant relied amongst others on the case of **Dessault Systems v. Dit (international taxation)** by the New Delhi Authority which stated that payment received by software developers from third party re-sellers on account of supplies of software did not result in income in the nature of royalty to the developer.

16. The Appellant further argued that payment made to the non-resident person was for copyrighted article and not copyrighted

right and could not be assessed as Royalty under Section 35 of the Act. Royalties it said are only payable on acquisition of the right to a copyright and in this instance no rights in relation to the copyright had been transferred or conferred on the licensee or the reseller and therefore Section 2 could not be applied as the payments were not royalty and therefore not subject to tax under Section 35.

17. The Appellant further contended that the Shrink-wrap license does not give the end-user the authority to exploit the copyright and therefore the sale of it should be treated as sale of copyrighted article as opposed to sale of rights in the software and the consideration cannot be termed as a royalty.

18. The Appellant went on to argue that the intellectual property rights in relation to the software are retained by the supplier and not given to the buyer of the software. The Appellant was of the view that the software is a tradable good where import and customs duty is paid. The software is not manipulated, not extracted and not modified. It is imported as is and delivered to the end user. As a result, the payment was a consideration for purchase of copyrighted Article and not for a copyright and therefore did not constitute income chargeable to tax for the purposes of withholding tax under Section 35.

RESPONDENT'S ARGUMENTS

19. The Respondent demanded Withholding Tax contending that consideration paid to a non-resident person by the Appellant for the software procured constituted a royalty and that they fell within the definition of royalty under section 35(1) of the income Tax Act (Act). It is the Respondent's submission that the Appellant's

argument that there are no guidelines in Kenyan legal and tax provisions on what exactly constitutes a royalty is baseless as the definition given by Section 2 of the Income Tax Act is clear, unambiguous and comprehensive. The Respondent argued that it is wrong for the Appellant to partially interpret the sub-paragraph by reading only subparagraph (a) and (d) and failing to consider the rest of the paragraph that states "and the gains derived from the sale or exchange of any right or property giving rise to the royalty"

20. The Respondent further submitted that it classified payment for software as payment for a consideration for the use of or the right to use a model as per sub-paragraph (d) of Section 2 of the Income tax act CAP. 470 and therefore the gains derived from the sale or exchange of the right or property gives rise to the royalty which provides a follows;-

Section 2 "Royalty means a payment made in consideration for the use of or the right to use;-

(a) The copyright of a literary, artistic or scientific work; or

(b) A cinematographer film, including film, or tape for radio or television broadcasting; or

(c) Patent, trade mark, design or model, plan, formula or process; or

(d) 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 the royalty"

21. The Respondent submitted that when a software developer sells the software to the Appellant they have sold their right or intellectual

property which then gives rise to the royalty and hence payment made for this exchange is indeed royalty.

22. The Respondent submitted that payment made by Seven Seas Technologies Limited were for software products and licensing fees and that under the Act, they were recognized as Royalties. To buttress the argument they relied on **Republic v Commissioner of Income Tax ex-parte SDV Transami (K) limited** which inter-alia held;

"A royalty is a payment made to the creator of an industrial or artistic work or design or contraption which bears a certain "capital" quality and which will serve intellectual or reproduction or entertainment purposes. It is for the clear benefits flowing from such works, that their authors or creators are paid royalties. By virtue of the Income Tax act (Cap 470), S.35(6), where a Kenya-based person makes such payments to a non-resident person, he is required to retain withholding tax, and remit the same to the Commissioner of Income tax"

23. The Respondent argued that the Appellant was using the copyrighted work and module pertaining to the software, so the payment would constitute a royalty. The Respondent went on to state that payment made by the Appellant was to acquire another person's intellectual property right and thus is a royalty payment and not dependent on whether the right to reproduce/exploit has been passed by the owner.

24. The Respondent rejected the contention by the Appellant that OECD had given a very comprehensive interpretation on what constitutes a royalty and what is not a royalty, and found that the

same is not applicable in the instant case as the local statutes are clear and unambiguous and it would therefore be unnecessary to look elsewhere for clarification. The Respondent went on to note that the said OECD definition of royalties under Article 12 (Appendix 4) differed from the Income Tax Act Cap 470 definition where the latter includes "*...and the gains derived from the sale or exchange of any right or property giving rise to the royalty*" and it was therefore not permissible to import the meaning assigned to one statute into a different statute.

25. The Respondent was adamant that copyrights in relation to the software were passed on by the supply to the buyer of the software packages and indeed the licensee was Seven Seas Technologies and not an end user as alleged by the Appellant. Hence, the payment constituted a royalty as it is not in dispute that the Appellant had entered into a contractual arrangement with the suppliers and it is clear the payment was for the license to use software packages. According to the Respondent, the Appellant was using the copyright work and module pertaining to the software and so the payment made would of necessity constitute a royalty.

26. The Respondent was of the firm position that the software purchased for own use or for resale falls within the definition of a royalty as envisaged under Section 2 of the Act.

ANALYSIS AND FINDINGS:

28. The dispute between the parties revolves around Section 35(1)(b) which provides as follows;

"A person shall, upon payment of an amount to a non-resident person not having a permanent establishment in Kenya in respect of

(a) .....

(b) a royalty or natural resource income;

(c) .....

which is chargeable to tax deduct therefrom tax at the appropriate non-resident rate"

29. Section 2 of the Income Tax Act (hereafter referred as the Act) then defines what royalty means.

"royalty" means a payment made as a consideration for the use of or the right to use –

(a) the copyright of a literary, artistic or scientific work; or

(b) a cinematograph film, including film or tape for radio or television broadcasting; or

(c) a patent, trade mark, design or model, plan, formula or process; or

(d) any industrial, commercial or scientific equipment, 8 of 1997 Section 27 Cap.485A. 38 of 2013 Section 9 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;

30. What required to be examined is whether payment made by the appellant to a non-resident person is in respect of royalty as covered by section 35(1)(b) of the Act, if not then the same will be taxable under business income

31. To be taxable as royalty the payment for the software should have been "for the use of or the right to use of" any copyright.

32. The Appellant is primarily into the business of provision of integrated business and technology solution procured from various Enterprise Resource Planning software manufacturers & Developers. The software procured is mainly sold to end users who are their clients, and the Appellant is merely a distributor of the software in Kenya. One such software developer, which is subject matter of the controversy, is called Callidus Inc. (USA). The Appellant's case hinges on payment made to a non-resident person as consideration for software procured and whether the payment qualifies to be taxed under "royalty" category pursuant to section 35(1) and Section 2 of Income Tax Act. It may be observed that the most important aspect of this definition is the use of the words "as a consideration for ....." this clearly implies that the purpose for which the consideration is paid is of paramount importance for the interpretation of the expression 'royalty'. Thus, only if some right in respect of a patent, invention, model, design, secret formula, process, copyright, literary or scientific work or the use of the right in a patent, invention, model, design, secret formula or process or trademark or similar property are transferred, it cannot be regarded as royalty. If the consideration is for the right to commercially exploit the intellectual property in the software, then the same could equal royalty.

33. The Tribunal looked at the word 'Copyright" as given in the Copyright Act Kenya (CAP.130). which gives what work is eligible for copyright.

Section 22(1) explain that subject to this section, the following works shall be eligible for copyright- (a) literary works; (b) musical

works; (c) artistic works; (d) audio-visual works; (e) sound recordings; and....

Section 2 says "literary work" irrespective of literary quality, include any of the following or works..... (a) novels, stories and poetic works; (b) plays, stage directions, film sceneries and broadcasting scripts; (c) textbooks, treatises, histories, biographies, essays and articles; (d) encyclopedias and dictionaries; (e) letters, reports and memoranda; (f) lectures, addresses and sermons; (g) charts and tables; (h) computer programs; and (i) tables and compilations of data including tables and compilations of data stored and embodied in a computer or a medium used in conjunction with a computer, but does not include a written law or a judicial decision. It is clear to the Tribunal from the above definition that a Computer program is qualifies as copyright work as mentioned is Section 22(1) (a). We also usefully refer to the OECD model convention Article 12(2) which throws considerable meaning to the word "Royalties" it means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model.....

34. We looked at one of the Software Supply contract for Callidus Software Inc. as representative of all the other purchase contracts as the contract would substantially be the same. The contract end user or licensee is Seven Seas Technologies, who the Appellant herein pays software license fees as per Clause 1 of the contract. Under Section 1 of the Copyright Act, "license" means a lawfully granted license permitting the doing of an act controlled by copyright;

There is nothing in the contract to state that license granted to the Appellant is a non-exclusive restricted license thus the Appellant has no limited right in as far as the use of the software is concerned. The Software Purchase Contract does not place any stringent restrictions on the Appellant in as far as the use of the software is concerned. It clearly shows that the licensee can exploit the computer software commercially which is the very essence of a copyright.

35. We also took note of Section 26(1) of the Copyright Act which enumerates what cannot be considered as infringement of copyright; Copyright in a literary, musical or artistic work or audiovisual work shall be the exclusive right to control the doing in Kenya of any of the following acts, namely the reproduction in any material form of the original work or its translation or adaptation, the distribution to the public of the work by way of sale, rental, lease, hire, loan, importation or similar arrangement, and the communication to the public and the broadcasting of the whole work or a substantial part thereof, either in its original form or in any form recognizably derived from the original; but copyright in any such work shall not include the right to control - (a) the doing of any of those acts by way of fair dealing for the purposes of scientific research, private use, criticism or review, or the reporting of current events subject to acknowledgement of the source;

We need not clarify that the Appellant has been given any of the rights mentioned in clause 26.

36. There is no clause in the Software Purchase Contract that runs counter to Section 26(1) of the Copyright Act which permits a

copyright holder to sell or let out on commercial rental the computer programs and for this reason it can be said the Appellant therefore acquired a right in the software. In other words, a holder of a copyright is permitted to exploit the copyright commercially and if he is no permitted to do so then what he has acquired cannot be considered a copyright. Clearly the Appellant is in the business of buying and selling Computer Programs thus exploiting the computer software commercially which is the very essence of a copyright.

37. We have no doubt that the products that Seven Seas Technology acquired were specialized in nature and supplied them to its customers as business. Be that as it may, the question whether the consideration paid resulted in transfer of a copyright right or a copyrighted article must be determined taking into account all the facts and circumstances of the case and the benefits and burden of the ownership which have been transferred. It is necessary to establish that there is a transfer of all or any rights (including the granting of any license) in respect of a copyright in "literary work" thus in order to treat the consideration paid by the Appellant as royalty; was established that the Appellant by making such payment obtained all or any of the copyright right of such "literary work".

38. The case of **Kenya Commercial Bank v Kenya Revenue Authority (2007)**, is instructive and we have taken the liberty to quote the word of **Justice Lesiit J.** *"The definition given to 'royalty' is wide which I think is an indication of the extensive range of underlying transactions giving rise to a royalty that the Income Tax Commissioner would target. The width of the definition is also*

important because in my view, it gives the Commissioner the right to seek withholding tax on royalty payments made offshore, and on the other hand he would expect to see similar payments being received in Kenya by the holders of Kenyan Intellectual Property that is used outside Kenya."

39. Copyright is a negative right in the sense that it is a right that prohibits someone else to do an act without the authorization of the same by the owner. It would therefore be necessary to look at it in terms of infringement. What has been excluded under section 4 of the Copyright Act is not commercial exploitation, but utilizing the copyrighted product for one own use.

" Notwithstanding the provisions of subsection (3), a person who is in lawful possession of a computer program may do any of the following acts without the authorization of the right holder whereby copies are necessary for the use of the computer program in accordance with its intended purpose - (a) to make copies of the program to the extent necessary to correct errors; or (b) to make a back-up copy; or (c) for the purpose of testing a program to determine its suitability for the person's use; or (d) for any purpose that is not prohibited under any license or agreement whereby the person is permitted to use the program."

When infringement is ruled out, it would be difficult to reach the conclusion that the buyer/licensee has acquired a copyright.

40. As stated in Copinger's treatise on copyright "the exclusive right to prevent copying or reproduction of a work is the most fundamental and historically oldest right of a copyright owner" we therefore do not agree that by the mere fact of downloading a computer program for own use is necessarily a transfer of rights in respect of copyright. Where the purpose of the license is only to establish access to the software for internal business purposes, then it would be incorrect to state that the copyright itself has been transferred. Merely using the data or the information in a computer program within the Appellant business premises does not amount to a transfer of rights of using the software.

41. The Appellant was allowed to use the software for its own use and the Appellant was notable to demonstrate that it was not permitted to loan/sale/sub-license the software to any third party.

In view of the elaborate analysis we find as follows;

i) The payment made by the Appellant as consideration on account of supply of software products to end-user customers results in payment in the nature of Royalty and therefore comes under the ambit of Sections 2 and 35 of the Income Tax Act. We are therefore in agreement with the Respondent.

ii) Secondly the Appellant procured a computer program to be used in its business and was allowed to use the software for its own use but the Appellant failed to demonstrate that it was not permitted to loan/sale/sub-license the software to any third party. In the result, the Appeal is thereby dismissed.

iii) By reason of the foregoing the Appeal herein is dismissed with No Orders as to Costs

DATED and DELIVERED at NAIROBI this 5TH day of DECEMBER 2016

In the presence of:-

MARTIN KISUU .....for the Appellant

MAFTAH OTUGI .....for the Respondent

.....
MOSES BUYUKA OBONYO
CHAIRPERSON

.....
JOLAWI OKELLO OBONDO
MEMBER

.....
PHILOMENA KIROKEN
MEMBER

.....
JOSEPH WACHIURI
MEMBER