A Critique of Intellectual Property as a Business Asset: Valuation, Commercialization, and Taxation of Intellectual Property in Kenya

By: ***Peter Mwangi Muriithi****

Abstract

The motivation behind this paper is to conceptualize the nature of intellectual property as a business asset in Kenya. The author intends to analyze the now widely accepted facets of intellectual property as a business asset namely valuation, commercialization, and taxation. Inquisitively the paper asks; What are the various approaches used when carrying out a valuation of intellectual property? How can intellectual property be commercialized in Kenya? How is intellectual property taxed in Kenya?

The author appreciates the jurisdictional nature of intellectual property; hence, the discussion hereinbelow is limited to Kenya. In doing so, the author shall; offer a brief introduction defining Intellectual Property, critique valuation, commercialization, and taxation of intellectual property in Kenya; and lastly, the paper shall give a conclusion.

1.0 Introduction

Intellectual property (hereinafter IP*)*, which includes, but is not limited to, trademarks, service marks, patents, copyrights, industrial designs, and trade secrets, represents rights, which, when legally protected, enable the owner of' the IP to preclude others from using and/or producing the protected IP.[1] The rights granted to the owner of the IP could translate into economic value since the owner has the legal ability to use the IP to his advantage and to prevent others from exploiting the particular idea or technology.[2]

The legal rights accorded to an owner of IP reflects public policy consensus to provide the developer /inventor and founder of the IP with the economic

****LL.B & LLM-University of Nairobi, PGDL, Patent Agent, Court Accredited Mediator, MCIArb, Publisher & Legal Audit & Compliance Officer. Email; muriithipitaz@gmail.com*

[1] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).
[2] Ibid No.1

benefits associated with such assets. Accordingly, the elements of value for IP assets is largely due to its legal "monopoly," which provides the basis and support for pricing premiums, cost savings, competitive and marketing advantages, and barriers to entry.[3]On this basis, IP as a business asset can be analyzed in three parts all of which are aimed at the economic benefits of IP to the developer/inventor. These are:

a)Valuation
b) Commercialization
c)Taxation

2.0 Valuation of IP

In order to address the issue of valuation of IP asset, there is a need to define what constitutes IP assets. *IP assets* are a subset of intangible assets and distinguished from other intangible assets by the fact that they are a creation of the law. As such, IP assets are legally protected and can be legally enforced.[4]

IP assets can be independently identified, are transferable and have an economic life (in contrast to their legal life, which is generally longer than their economic life). IP assets include patents, industrial designs, trademarks, copyright, and trade secrets e.t.c.[5] There are two perspectives that can be adopted in defining an IP asset namely; legal and economic perspective.

Legal perspective: An IP asset can be defined in terms of particular qualitative characteristics or standards (such as that of novelty, originality). *Economic perspective*: An IP asset can be defined in terms of the economic benefit linked to the IP asset. For example, a patent that has not contributed to the production or protection of income has no economic value, even though it has legal existence.[6]

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[3] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).
[4] WIPO- IP valuation <https://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_11_learning_points.pdf>lastly accessed on 5th April, 2021.
[5] Ibid No.4
[6] WIPO- IP valuation

Value of an IP Asset

The value of an IP asset derives, in essence, from *its ability to exclude competitors from a particular market***.** Whilst the legal right grants exclusivity or the right to exclude, the economic rights are based on exclusivity of use, that is, the ability to control the use of the IP asset.[7]

For an IP asset to have a quantifiable value, it should:

a)generate a measurable amount of economic benefit to its owner/user.

b)enhance the value of other assets with which it is associated.

This *"hidden" value* associated with IP assets along with the increase in the nature and type of IP assets being accorded legal protection on a worldwide basis have offered businesses new global opportunities to leverage the use of their IP. This has been achieved by expansion into new markets through the use of strategic alliances, licensing agreements, and joint ventures. Accordingly, companies and individual proprietors have expanded the scope and use of their IP to provide new and innovative opportunities to achieve improved financial results in the form of increased sales, profitability, market share, and shareholder value and certain related benefits in the form of greater consumer awareness, public recognition, and overall acceptance of their IP assets.[8]

Defining IP Valuation

IP Valuation succinctly can be referred to as a process to determine the monetary value of subject IP.[9] This involves bringing together the economic concept of the value and the legal concept of property.[10]

<https://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_11_learning_points.pdf>lastly accessed on 5th April, 2021.

[7] Ibid No.6

[8] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).

[9] WIPO- IP valuation. <https://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_11_learning_points.pdf>lastly accessed on 5th April, 2021.

[10] WIPO, The Value of Intellectual Property, Intangible Assets and Goodwill <https://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html> lastly accessed on 5th April, 2021

Importance of IP Valuation

An assessment of the validity, strength, protection and remaining life of the IP is very much needed before starting an exploitation activity. In the same way, after the conception of an invention, it is important to consider whether the IP still needs further development or it is ready to be commercialized. It should be borne in mind that where it is decided to commercially exploit an IP asset that is still in the development phase, the business effort can be greater, given the greater uncertainty surrounding its commercial success and the consequent economic return.[11]

With the increasing contribution of intangible assets, such as IP, in business growth, it has now become imperative to measure and determine its value. This is important because, in every business transaction, it would be inevitable to factor in the contribution of the intangible assets. Interestingly, however, this value or contribution varies depending on the kind of business transaction, and it is in this sense that one must be able to determine the various uses of IP valuation.[12]

Moreover, valuing and financing IP creates a multiplier effect not just for the business sector but also for the government. If a standard in valuation and financing IP is established, investments beneficial both for the economy and the industry will come in and numerous expansions will happen. This will mean added jobs, bigger researches, and more opportunities. Premised on this understanding the potentials IP brings to an industry and to the economy can be massively felt not just nationally but also globally.[13]

Enunciating Intellectual Property Valuation Approaches

IP has *value* to an individual proprietor or company in part because it enables such an individual proprietor or company to conduct operations with the knowledge, experience, and reputation that has been derived through the

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[11] Roberto d'Erme, Intellectual Property commercialisation highlights (European IPR Helpdesk).
[12] APEC Intellectual Property Experts Group, Intellectual Property (IP) Valuation Manual: A Preliminary Guide
January 2018.
[13] APEC Intellectual Property Experts Group, Intellectual Property (IP) Valuation Manual: A Preliminary Guide January 2018.

development of a particular IP asset. The development of IP generally takes years of marketing, advertising, and/or research and development support and refinement. As a result, it is hoped that the IP will enable consumers to easily identify with an individual proprietor's or company's products or services and, thereby, generate widespread and consistent demand for such products and services.

The following are the conventional and accepted approaches to estimate the fair market value of IP:

1. The Market Approach
2. The Cost Approach
3. The Income Approach
4. The Royalty Approach

1. The Market Approach

The Market Approach is a valuation technique by which fair market value is estimated based on arm's length exchange prices in actual transactions and on asking prices for assets currently offered for sale.[14] The market approach method is based on comparison with the actual price paid for a similar IP asset under comparable circumstances. To do a valuation with this method, one needs to have:[15]

a) An active market (price information, arm's length)
b) An exchange of an identical IP asset, or a group of comparable or similar IP assets
c) If the IP assets are not perfectly comparable, variables to control for the differences

The more information available on the nature and extent of rights transferred, including the detailed terms and conditions, the circumstances of the transaction (e.g., cross-licence, licence agreed in settlement of litigation), the

[14] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).
[15] WIPO, The Value of Intellectual Property, Intangible Assets and Goodwill <https://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html> lastly accessed on 5th April, 2021.

more accurate the valuation will be. This method is much more likely to reflect market perceptions and moods than a valuation based on the income method.[16]

Market-based approaches can be used as a primary methodology for determining the level of investment in early-stage companies, with net assets (or cost approaches) utilized as a cross-check of these values. Market-based valuations are recommended when conducting a valuation to[17]:

a)determine licensing royalty rates;
b)secure financial investment and determine the level of equity, and
c)assist decision-making for strategic business development in the enterprise.

2. The Cost Approach

The Cost Approach is a valuation technique that uses the concept of replacement cost as an indicator of value. The premise of the Cost Approach is that a prudent investor would pay no more for an asset than the amount for which the asset could be replaced.[18]

The cost method is primarily based on the intention of establishing the value of an IP asset by calculating the cost of developing a similar (or exact) IP asset either internally or externally. It seeks to determine the value of an IP asset at a particular point of time by aggregating the direct expenditures and opportunity costs involved in its development and considering obsolescence of an IP asset.

For example, if the IP owner has data pertaining to the cost it incurred for the preceding five years and wants today's value of that IP, the cost incurred in its development, adjusted to inflation, will provide a current value which, in turn, will be further adjusted for obsolescence to arrive at a final opinion of its value.[19] The cost method is generally the least used method as, in most

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[16]Ibid No.15.
[17] APEC Intellectual Property Experts Group, Intellectual Property (IP) Valuation Manual: A Preliminary Guide January 2018.
[18] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).
[19] WIPO, The Value of Intellectual Property, Intangible Assets and Goodwill

cases, it is considered suitable only as a supplement to the income method (if the valuation is not for bookkeeping purposes). The method is normally used in situations where the subject IP is currently not generating any income.[20]

It is recommended that the cost approach be used for[21]:

a)legal and accounting standards requirements (including determining damages from potential IP infringements); and
b)taxation, particularly capital gains tax and stamp duty liabilities.

3. The Income Approach

The Income Approach is a valuation technique by which the value of IP is estimated by the income generated by the particular IP asset. This looks at the stream of income attributable to the intellectual property based on the historical earnings and expected future earnings. The income method values the IP asset on the basis of the amount of economic income that the IP asset is expected to generate, adjusted to its present-day value. This method is the most commonly used method for IP valuation.[22]
How to determine economic income

a)Project the revenue flow (or cost savings) generated by the IP asset over the remaining useful life of the asset.
b)Offset those revenues/savings by costs related directly to the IP asset. Costs: labour, and materials, required capital investment, and any appropriate economic rents or capital charges
c)Take account of the risk to discount the amount of income to a present-day value by using the discount rate or the capitalization rate

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<https://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html> lastly accessed on 5th April, 2021
20 Ibid No.19
21 APEC Intellectual Property Experts Group, Intellectual Property (IP) Valuation Manual: A Preliminary Guide January 2018.
22 WIPO, The Value of Intellectual Property, Intangible Assets and Goodwill <https://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html> lastly accessed on. 5th April, 2021.

Different measures of economic income may be relevant to the various income methods. Some of these measures include the following: Gross or net revenues, gross profit, net operating income, pretax income, net income (after-tax), operating cash flow, net cash flow, incremental income, and cost savings.[23]

Given the different measures of economic income that may be used in the income approach, an essential element in the application of the income method is to ensure that the discount rate or the capitalization rate used is derived on a basis consistent with the measure of economic income used.[24]

4. The Royalty Savings Approach

The Royalty Savings Approach, a variation of the Income Approach, is a technique by which fair market value is estimated based on the after-tax royalty savings an IP asset can be expected to generate in the future. In the Royalty Savings Approach, the value of IP is estimated by capitalizing the royalties saved because the company owns the IP. [25]

In other words, the owner of' the IP realizes a benefit from owning the IP rather than paying rent or royalty for the use of the asset. An integral and initial step in the estimation of the fair market value of the IP by using the Royalty Savings Approach involves estimating a royalty rate.[26]

The Challenge of Valuing Intellectual Property Assets

Valuing IP assets is seminal especially in the commercialization of IP assets. However, there are various challenges associated with the valuation of IP assets. Valuing IP assets requires that a company or an individual proprietor to (1) identify the IP assets, and (2) assign a justifiable value to the identified IP assets, both of which require careful consideration. A company or an individual proprietor may possess various types of assets that qualify as IP.

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[23] Ibid No.22

[24] WIPO, The Value of Intellectual Property, Intangible Assets and Goodwill <https://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html> lastly accessed on. 5th April, 2021.

[25] Ashok K. Jain, Valuation of Intellectual Property 16 IPL Newsl. 6 (1997).

[26] Ibid No.25

By its very nature, IP comprises intangible assets that are not as readily identifiable as other tangible assets (e.g., buildings, equipment, etc.) [27]

In some instances, IP rights are embodied in a granting document, such as an issued patent or a registered trademark. In those instances, the IP assets may be more easily identified by a company or an individual proprietor.[28] Consequently, a company or an individual proprietor may possess a vast amount of IP assets, some of which are readily identifiable and others of which are difficult to identify. In such a situation, the question arises of how can a company or an individual proprietor be confident that they are aware of all of their IP assets? The certainty of what constitutes a company or an individual proprietor IP assets' remains a seminal challenge in the valuation of IP assets. This is because those IP assets which are difficult to identify may be inadvertently excluded when an IP valuation is being carried out.

However, a solution to this challenge may lie in performing an IP audit. A comprehensive IP audit generally includes an evaluation of a company or individual proprietor assets to identify the IP assets that they possess. For instance, an IP audit identifies such IP assets as a company or individual proprietor issued patents, registered trademarks, registered copyrights, and trade secrets. Such an audit also identifies IP assets acquired or licensed from third parties. Further, an IP audit identifies IP assets possessed by a company or individual proprietor that does not confer presently enforceable rights, such as pending patent and trademark applications and inventions disclosed to an individual proprietor or company decision-making personnel, for which a patent application is yet to have not been filed. The IP audit may further evaluate a company or individual proprietor process of collecting IP assets. For instance, a company or individual proprietor may have procedures

[27] Jody C. Bishop, The Challenge of Valuing Intellectual Property Assets, 1 Nw. J. Tech. & Intell. Prop. 59 (2003).
https://scholarlycommons.law.northwestern.edu/njtip/vol1/iss1/4

[28] Jody C. Bishop, The Challenge of Valuing Intellectual Property Assets, 1 Nw. J. Tech. & Intell. Prop. 59 (2003).
https://scholarlycommons.law.northwestern.edu/njtip/vol1/iss1/4

in place to encourage their employees to disclose their inventions to the company or individual proprietor.[29]

An IP audit may also include an evaluation of the procedures put in place by a company or individual proprietor for maintaining the IP assets. For example, the Kenya Industrial Property Institute in Kenya requires companies to pay periodic fees to maintain patents in force. Similarly, intellectual property rights licensed from third parties may require periodic payments to be made to the third parties. Thus, an IP audit may evaluate the existing procedures for ensuring payments for maintaining a company or individual proprietor IP assets in force.[30]

Once a company or individual proprietor identifies the IP assets, it becomes desirable to assign a justifiable value to those assets. One study reported that while in 1978 only twenty per cent of corporate assets were intangible assets, and eighty per cent of corporate assets were tangible assets, by 1997 the relative value of tangible and intangible assets had practically reversed, with seventy-three per cent of corporate assets being intangible assets.[31]

Thus, for many a company or individual proprietor, valuation of their IP assets is a critical factor in determining their financial condition. Valuing IP assets is often a difficult task because their true value may not be readily apparent. It is often desirable to tie the value of an IP asset to income directly attributable to that asset, if determinable. [32]

Of course, the value of an IP asset may not be recognized in income received by a company or individual proprietor. Indeed, the full value of an IP asset is likely never to be recognized in income because much of the asset's value resides in the negative right to prevent others from doing something they would otherwise be permitted to do. Thus, a patent may have great value

[29] Jody C. Bishop, The Challenge of Valuing Intellectual Property Assets, 1 Nw. J. Tech. & Intell. Prop. 59 (2003).
https://scholarlycommons.law.northwestern.edu/njtip/vol1/iss1/4
[30] Ibid No. 29
[31] Kenneth E. Krosin, Management of IP Assets, AIPLA BULLETIN 176 (2000 Mid-Winter Meeting Issue).
[32] Ibid No. 31

even if a company or individual proprietor does not license the patent or enforce the patent against any third parties because a company or individual proprietor possesses "the right" to prevent others from practising the patented invention. For example, potential competitors may decide not to embark on a field encompassed by a company or individual proprietor patent rights.[33]

Valuing an IP asset is further complicated because such value is generally not stagnant. Rather, the value of an IP asset often changes over time. Consequently, a company or individual proprietor should periodically (e.g., annually) re-assess the value of its IP assets.

While each of the Intellectual valuation techniques may fail to capture the full value of an IP asset, its use should provide comfort to a company or individual proprietor company's officers that they have reasonably valued their IP assets in assessing their financial condition. As the reporting of a company or individual proprietor financial condition continues to be more closely scrutinized, the valuation of IP assets becomes increasingly important, particularly if much of a company's or individual proprietor's financial value resides in the IP assets.[34] Lastly, the existence of limited skilled IP valuers' in Kenya remains a challenge, that needs to be addressed through training and adoption of global best practices.

3.0 Commercialization of IP assets

It is by commercializing Intellectual property that a person or organization are able to reap the economic benefits from their knowledge/invention and even make it a bit more physical. *Commercialization* is the process of bringing the IP to the market in order for it to be exploited in return of business profits and growth.[35] The financial success of any IP commercialization will certainly depend on the choice of the most appropriate commercial tool.[36]

[33] Kenneth E. Krosin, Management of IP Assets, AIPLA BULLETIN 176 (2000 Mid-Winter Meeting Issue).
[34] Ibid No.33
[35] Roberto d'Erme, Intellectual Property commercialisation highlights(European IPR Helpdesk).
[36] Ibid No.35

Forms of commercialization of IP assets

Generally, intellectual property may be commercialized by:

1. In-House exploitation,
2. By a permanent assignment or
3. By entering into different types of business partnerships, such as licensing, franchising, joint venture or Spin-off Company.

A. An in-house exploitation/Internal product development:

This is one of the most common ways to commercialize IP assets. This form of commercialization is usually adopted by organizations or individual proprietors, that have the requisite competencies and resources to manufacture and supply goods or services. It is worth noting that optimal management of the IP concerned, is needed here if the individual proprietor or organization wishes to leverage its business growth with its own development of the knowledge produced. [37]

B. By a permanent assignment

This is meant to be an ordinary sale and occurs when an assignor permanently transfers the ownership of its IP asset to an assignee, who will acquire the full rights to dispose of the intangible asset in question unless the assignor asks to be licensed back. [38]

It is usually done through *ad hoc* assignment contracts but it is possible to include assignment clauses within partnership and employment agreements. As with licences, assignment of IP is done in return for a payment of a lump sum, royalties, or a combination of both.[39]

[37] Roberto d'Erme, Intellectual Property commercialisation highlights(European IPR Helpdesk).
[38] Roberto d'Erme, Intellectual Property commercialisation highlights(European IPR Helpdesk).
[39] Ibid No.36

C. By entering into different types of business partnerships, such as licensing, franchising, joint venture or Spin-off Company.

This involves the developer/inventor entering into different partnerships. For example:

(i) Licencing

A licence is a permission to do something that would otherwise be unlawful.[40] This often happens when an organization or an individual lack the financial or technical capabilities to directly exploit their IP. Through a licence agreement, the owner of an IP (licensor) allows a third party (the licensee), to access and use their IP for a certain time period in return for financial compensation, either in the form of royalties on products sales or payment of a lump sum. The terms of licence agreements may vary widely, but they commonly provide for the exclusivity or non-exclusivity of the licensed technology, namely the right for the licensee to use the IP solely or in conjunction with the licensor. [41]

A licence can also be restricted to a particular purpose, such as research, development, selling or manufacturing purposes.[42]
Licencing takes various forms:

a)Voluntary or contractual licensing
b)Involuntary licensing such as compulsory licensing. Compulsory licencing is defined as an authorisation given by a national authority to a person, without or against the consent of the IP-holder, for the exploitation of the subject matter protected by a patent or other IP right.[43]

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[40] Ben Sihanya, Intellectual Property and Innovation Law in Kenya and Africa, Transferring Technology for Sustainable Development(1st Edition, Sihanya Mentoring & Innovative Lawyering, 2016) page 38.
[41] Ibid No.41
[42] Roberto d'Erme, Intellectual Property commercialisation highlights (European IPR Helpdesk).
[43] Ben Sihanya, Intellectual Property and Innovation Law in Kenya and Africa, Transferring Technology for Sustainable Development(1st Edition, Sihanya Mentoring & Innovative Lawyering, 2016)page 38.

Licensing can also be defined in terms of whether the licensee is sole, exclusive or non-exclusive.[44]

a)Sole licensing is where there is only one licensee. However, the licensor may compete with the Licensee.
b) Exclusive licensing is where no one may compete with the sole licensee including the licensor.
c)Non-exclusive licensing is where there is more than one licensee. They may compete among themselves and the licensor can also compete with them.

(ii) Spin-off Company

Spin-offs, also known as "*spin-outs*", are separate legal entities created by a parent organization to exploit its IP assets. [45] Once the company is established, the parent organization will assign or license the IP concerned to the spin-off to commercialize it. Spin-offs are a common commercialization practice in Universities and Research Organizations in order for them to exploit and maximize the economic benefits of the knowledge created.[46]

(iii) Franchising

This translates into the acquisition by the company of rights in the innovation, technology, skill, technical information, reputation or brand in the form of the appropriate trademark, service mark, copyright or trademark. An individual or company wishing to exploit the innovation or brand does so by investing in a company to utilize the brand. [47] Both parties benefit. Thus, successful copyright or trademark owners usually create franchises to

[44] Ibid No.42 page 38.
[45] Roberto d'Erme, Intellectual Property commercialisation highlights (European IPR Helpdesk).
[46] Roberto d'Erme, Intellectual Property commercialisation highlights (European IPR Helpdesk).
[47] Ben Sihanya, Intellectual Property and Innovation Law in Kenya and Africa, Transferring Technology for Sustainable Development(1st Edition, Sihanya Mentoring & Innovative Lawyering, 2016) page 513.

facilitate the exploitation of their intellectual property (IP), innovation or technology. [48]

Franchising is a form of technology transfer whereby the franchisor authorizes the franchisee to use the franchisor's copyright or trademark in exchange for royalties and related consideration.[49] Franchising involves a lot of advertising, and packaging of the products to suit customer tastes in the relevant market. Examples of franchising transactions are in the petroleum industry, food chains, fabrics and textiles, cinema and related lines of business Examples include; Java, Total, Kobil, Steers, Nandos, Caltex, Mobil, Mother Care, Victoria Secrets and McDonald's. [50]

(iv) Joint Venture

This is a form of business association between two or more independent organizations (joint venturers) to undertake a common project or to achieve a certain goal. This is an agreement in which one investor brings money and the other technology or know-how, (human resources, or distribution network) and they come together to complement each other. [51]

This may be done by way of a merger or through a strategic allegiance between stand-alone enterprises. A good illustration is the mergers between African governments and companies. Companies would be interested in such ventures or alliances for purposes of protecting their investments from political risk.[52]

More specifically, the parties to the joint venture share risks and contribute with their intellectual capital towards technology research and development,

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[48] Ibid No. 46.

[49] Roberto d'Erme, Intellectual Property commercialisation highlights (European IPR Helpdesk).

[50] Ben Sihanya, Intellectual Property and Innovation Law in Kenya and Africa, Transferring Technology for Sustainable Development(1st Edition, Sihanya Mentoring & Innovative Lawyering, 2016) page 513.

[51] Roberto d'Erme, Intellectual Property commercialisation highlights(European IPR Helpdesk).

[52] Ben Sihanya, Intellectual Property and Innovation Law in Kenya and Africa, Transferring Technology for Sustainable Development(1st Edition, Sihanya Mentoring & Innovative Lawyering, 2016) page 39.

production, marketing and commercialisation. The role that IP plays in conducting such collaboration is a central one, it is fundamental that joint venturers clearly define at the outset the ownership of the IP to be created by the joint venture and the other parties' rights to it.[53]

4.0 Taxation of IP in Kenya

Taxation of IP is territorial in nature. Generally, the treatment of tax on income related to intellectual property is dependent on the nature of income and the activity generating the income, who owns the property, and who makes the payment.

Main legal framework providing for taxation of IP is: **Income Tax Act Cap 470** (precisely; Section 2(defining a royalty, resident and permanent establishment), Section 3(1), Section 3(2) (a) (iii), Section 6(1), Section 35 (1)(b), Section 35 (3)(b), Section 35 (5) and First schedule Part 1 (11).

A succinct analysis of Taxation of IP

First, it is important to appreciate the nature of the income tax in Kenya. Under the provisions of the Income Tax Act, Cap 470, Laws of Kenya ("the Act") at Section 3(1) income tax is imposed upon all income of a person, if the same was accrued in or derived from Kenya.[54] Further, the principles of *worldwide* and *source basis* apply to individuals. This simply means Kenyan residents are taxed on their worldwide income while non-residents are taxed on the income from a source within the territory.[55]

Generally, the treatment of tax on income related to intellectual property is dependent on the nature of income and the activity generating the income, who owns the property, and who makes the payment. A transfer or a license

[53] Roberto d'Erme, Intellectual Property commercialisation highlights(European IPR Helpdesk).
[54]Section 3 (1) of Income Tax Act Cap 470 provides verbatim "Subject to, and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya."
[55] Victor Kiamba, Income Tax Liability on Intellectual Property <https://stralexgroup.blogspot.com/2016/06/income-tax-liability-on-intellectual.html> lastly accessed on 6th April, 2021

of intellectual property depends on whether all the rights to the property have been transferred.[56]

Income from a transfer or licensing of intellectual property may subsequently give rise to a capital gain or loss as well as withholding tax. If the income is accrued to or received by an individual in the furtherance of a business, it may then attract ordinary income tax liability with certain tax deductions and rebates while if in the course of employment, depending on the nature of the employment contract, to ordinary income tax. Amounts received by individuals who create intellectual property may be royalties or compensation, depending on whether they own and license the property or create it for an employer.However, the Act seemingly compounds such amounts as royalties for purposes of income tax.[57]The definitive section of Income Tax Act Cap 470,[58] defines *royalty* as a payment made as a consideration for the use of or the right to use:

> a)any copyright of a literary, artistic or scientific work; or
> b)any cinematograph film, including film or tape for radio or television broadcasting; or
> c)any patent, trademark, 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 any gains derived from the sale or exchange of any right or property giving rise to that royalty;

The provisions of Section 10 of the Act[59] deem payments in respect of royalties, among others stated under the said section, from a resident or a person having a permanent establishment in Kenya to any other person, to be income, which has accrued in or derived from Kenya.

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[56] Ibid No. 54
[57] Victor Kiamba, Income Tax Liability on Intellectual Property <https://stralexgroup.blogspot.com/2016/06/income-tax-liability-on-intellectual.html> lastly accessed on 6th April, 2021
[58] Section 2 of Income Tax Act Cap 470.
[59] Income Tax Act Cap 470.

Two salient features arise from the provisions of Section 10 of the Income Tax Act Cap 470:

1)*That the payment of the amount constituting the income must be from a resident or a person having a permanent establishment in Kenya*. This is in line with the *OECD Model Tax Treaty Principles* where the source of royalties is based on the tax residence of the party paying the royalties or on royalties having an economic link with a permanent establishment. This removes any focus on the party creating, devising or developing intellectual property and instead focuses on the party making the payment and thus if the party paying the royalty is a resident or a person having a permanent establishment in Kenya, the source of such income is said to be from within the Republic. [60]

A Permanent Establishment is defined in the Act[61] as a fixed place of business in which that person carries on business. A building site, or a construction or assembly project, which has existed for six months or more is deemed to be a fixed place of business.

2)*That such payment is made to any person, resident or not;* the main problem arising from this is *double taxation*. This may come about where a person who has received such payment, not being a resident, is liable to tax in Kenya on source basis while the jurisdiction where he/she is a tax resident imposes a tax on a worldwide income.

Tax Administration

The taxes are deducted at source as **withholding tax** and are at the rate of *5% for payments to a resident* and *20% for payments to a non-resident*.[62] The deductions are carried out by the person making the payment and shall according to Section 35 of the Income Tax Act[63], be remitted to the

[60] Victor Kiamba, Income Tax Liability on Intellectual Property <https://stralexgroup.blogspot.com/2016/06/income-tax-liability-on-intellectual.html> lastly accessed on 6th April, 2021

[61] Section 2 of Income Tax Act Cap 470.

[62] <https://www.kra.go.ke/en/helping-tax-payers/faqs/more-about-withholding-tax> lastly accessed on 6th April 2021.

[63] Cap 470.

Commissioner together with a *return* in writing of the amount of the payment, the amount of tax deducted, and such other information as the Commissioner may specify. He/she shall also indicate the person to whom the payment is made with a Certificate stating the amount of the payment and the amount of the tax deducted.[64]

Exemption to the taxation of IP

The Minister (in charge of Treasury) may, by notice in the Gazette, provide that income or a class of income which accrued in or was derived from Kenya to be exempt from tax to the extent specified in the notice.

Part 1 of the First Schedule to the Income Tax Act, provides at paragraph 11 *verbatim* that; *the income of a person from a management or professional fee, royalty or interest, may be exempt from tax when the Cabinet Secretary certifies that it is required to be paid free of tax by the terms of an agreement, to which the Government is a party either as principal or guarantor and that it is in the public interest that the income be exempt from tax*.

It is to be noted that the exemptions are not guaranteed and are solely the decision of the minister in charge.[65] Taxation of IP as a business asset has been subject to litigation in Kenyan courts for example:

The High Court recently delivered its judgment in the case of; *Vivo Energy Kenya Limited v Kenya Revenue Authority [2016] eKLR* [66] holding that the Commissioner of Domestic Taxes erred for concluding that a non-exclusive and non-transmissible license to use "Shell" trademarks was a sale of a property giving rise to royalty within the meaning of Section 2 of the Income Tax Act and hence chargeable to tax.

According to Vivo, it had only been granted non-exclusive and non-transmissible rights to use the trademarks, the manifestations and the right to include the word "SHELL" In its name in Kenya, without payment of

[64] Section 35(5)of Income Tax Act Cap 470.
[65] Victor Kiamba, Income Tax Liability on Intellectual Property <https://stralexgroup.blogspot.com/2016/06/income-tax-liability-on-intellectual.html> lastly accessed on 6th April, 2021
[66] eKLR **Civil Suit No. 507 Of 2014.**

royalty. Further, Vivo contended that the amount of Kshs. 427,964,870/- it was paid by Shell was not taxable income but a contribution for Research and Development.

However, Vivo was also of the view that even if the money in question was utilized for the acquisition of intangible assets, the said payment could not have amounted to a royalty, as defined in the Income Tax Act. Vivo argued that it had not acquired the trademark but rather it was only given non-exclusive and non-transmissible rights to use "Shell" trademarks in Kenya. Therefore, the Shell retained ownership of the trademarks and that Vivo was obliged to seek the consent or the concurrence of the owner if Vivo wished to either transfer or to transmit any of the rights conferred upon it under the license.

The court reasoned that the significant part of section 2 of the Act is that a royalty is "a payment made as a consideration" Since in this case, money was paid the court stated that the question to be answered is whether or not such payment was consideration for the purposes of Vivo being permitted to use the "Shell" trademarks.

In finding for Vivo, the court stated as follows:
"Both parties acknowledge that the appellant did not own the trademarks. Therefore, if the appellant was paid, it cannot have been for the trademarks. (...) The payment was specifically for Research and Development. This is my understanding, that the appellant [Vivo] when putting to use the trademarks and manifestations, was expected to carry out research and development.
...However, as the said trademarks did not belong to the appellant, the benefit, in the long run, would go to SBI [Shell]. (...) In that respect, the payment was of a capital nature. It was not money which the appellant was to use for trading. (...) Accordingly, I set aside the decision of the Local Committee dated 19th September 2013, and hold that the payment was not royalty, and it was not taxable. The payment was of a capital nature."
In light of the above, the court concluded that the payment was not a gain derived from the sale of a property, giving rise to royalty under the Act.

5.0 Conclusion

From the above discussion, it is clear that the discourse of IP as a business asset addresses the very basis of the existence of IP. On this basis, there is a need to have in place an enabling legal framework to promote the exploitation of IP as a business asset. This paper propounds that IP is the next frontier for exploitation by innovative and enterprising entrepreneurs, and the valuation, commercialization and taxation of IP will be inseparable in this undertaking.

Rhetorically, this paper questions; What is the role of advocates in valuation, commercialization and taxation of IP as a business asset in Kenya? Is there need for a legislation to promote valuation, commercialization and taxation of IP as a business asset in Kenya?

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