Hong Kong Tax Alert

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Court held that sub-licensing income for the exploitation of trademarks registered overseas to be taxable onshore income

- *the decision lends support to the assessing practice adopted by the Inland Revenue Department (IRD) in this regard and indicates that any attribution of the activities performed by an agent overseas to the taxpayer in Hong Kong for determining the source of profits of the latter under a joint venture type of arrangement would need to be made with caution. The case for such attribution would be further undermined where the "agent" does not conclude the relevant contracts for the taxpayer.*

Brief facts of the case[1]

The Taxpayer was incorporated in Hong Kong by its parent company (Hookedge UK) to exploit certain trademarks, which were owned by Hookedge UK and licensed to the Taxpayer pursuant to a master license (the Trademarks; the Master License).

The Taxpayer wished to exploit the Trademarks in a number of jurisdictions, including Japan. On 21 January 2009, the Taxpayer (then known as Hookedge Limited) entered into an agreement (the Deed of Cooperation) with British Luxury Brands Group Ltd (BLBG) for this purpose.

Upon signing the Deed of Cooperation, the Taxpayer received an initial fee of £500,000 (Upfront Payment) for its granting to BLBG the right to participate in the management of the business of the design, manufacture, distribution and sale of certain products under the Trademarks in Japan.

Under the Deed of Cooperation, (i) the Taxpayer was to grant sub-licenses to Japanese companies introduced by BLBG for the use of the Trademarks in Japan; and (ii) the royalty income received by the Taxpayer was to be shared between the Taxpayer and BLBG in the ratio of 40:60, subject to the Taxpayer's entitlement to retain US$750,000 of the gross royalty income received each year.

The Commissioner of Inland Revenue's (CIR) determination that both the Upfront Payment and the Taxpayer's 40% share of royalties (the 40% Royalties) were taxable onshore revenue income for the four years of assessment 2009/10 to 2012/13 was upheld by the Board of Review (BOR).

The Taxpayer appealed to the Court of First Instance (CFI) against the BOR's decision.

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1. *Patrick Cox Asia Limited v The Commissioner of Inland Revenue* [2023] HKCFI 2676

Decision of the CFI

The Taxpayer's grounds of appeal were that the BOR erred:

(1) in not finding that it carried on a specific trade or business of licensing the Trademarks to Japanese sub-licensees not in Hong Kong but in Japan

(2) in applying the case-law principles in concluding that the proximate source of the 40% Royalties and the Upfront Payment were operations conducted by the Taxpayer in Hong Kong and, in the process, disregarding the role played by BLBG as its agent in Japan

(3) in holding that the Upfront Payment was not a capital but a revenue receipt

Whether there was a specific trade or business of licensing the Trademarks to Japanese sub-licensees not in Hong Kong but in Japan

At the CFI, while admitting that the businesses of licensing operations regarding trademarks registered outside Japan were carried on in Hong Kong, the Taxpayer argued that the specific trade or business of licensing the Trademarks to Japanese sub-licensees was however not carried on in Hong Kong but in Japan.

The CFI however noted that (i) such an argument was not advanced by the Taxpayer before the BOR and (ii) the BOR found that the Taxpayer only carried on a single trade or business in Hong Kong, namely the business of licensing the Trademarks whether in Japan or other locations.

As such, it was not open to the Taxpayer to now seek to argue at the CFI that the BOR erred in failing to find that the Taxpayer conducted multiple businesses and that one of these businesses was not conducted in Hong Kong.

As regards whether the BOR erred in concluding that the Taxpayer carried on its single business of licensing the Trademarks in Hong Kong, the CFI noted that this conclusion was based on at least eight pieces of evidence, including the fact that the Deed of Cooperation and the sub-licensing agreements were executed by the Taxpayer in Hong Kong. However, the Taxpayer only challenged three of them.

The first piece of evidence challenged was that the BOR took into account the designation of a Hong Kong business address in the director's report of the Taxpayer. The CFI however considered that the *Newfair Holdings Limited v CIR*[2] did not lay down any principle that having a registered address in Hong Kong as a formality of corporate law would necessarily be insufficient to constitute the conduct of a trade or business in Hong Kong, such an issue necessarily turning on the specific facts of each case.

The second specific matter complained of by the Taxpayer was that the BOR referred to the Taxpayer obtaining the right to license the Trademarks from Hookedge UK pursuant to a board meeting of Hookedge UK held in Hong Kong. The CFI however considered that the BOR was simply referring to the board meeting as part of the evidential background rather than imputing any act of Hookedge UK to the Taxpayer.

As regards the third specific matter complained of by the Taxpayer that it was "set up to carry on the business of sub-licensing the Trademarks…in Hong Kong", the CFI noted that this was in fact the BOR's conclusion after a consideration of the relevant evidence.

Given that the issue involved was whether there was evidence to support the BOR's finding that the business was as a matter of fact carried on in Hong Kong, and not whether each and every piece of evidence supported the finding, or how the various pieces of evidence should have been weighted and evaluated by the BOR as a fact-finding tribunal, the CFI held that there was no merit in this ground of appeal.

The proximate source of the 40% Royalties and Upfront Payment

The Taxpayer argued that the fact the Deed of Cooperation and the Japanese sub-licenses were executed in Hong Kong did not mean that the 40% Royalties and the Upfront Payment were sourced in Hong Kong.

Relying on the recital of each of the Japanese sub-licenses stating that the Taxpayer had appointed BLBG as its agent in Japan, the Taxpayer argued that "[t]he principle of agency in the broad sense approved by the Court of Final Appeal in *ING Baring*[3] should therefore in principle have applied".

The Taxpayer therefore contended that the BOR was wrong in considering that the most important factor in ascertaining the locality of the Taxpayer's profit being that Antares Cheng, the Hong Kong based director of the Taxpayer, was the ultimate decision maker and had the final say as to whether to enter into a sub-license.

The argument of the Taxpayer was that the BOR wrongly applied the "brain analogy" to conclude that since Antares Cheng, the ultimate decision maker of the Taxpayer, was located in Hong Kong, the source of the 40% Royalties must have been where he decided to enter into the Deed of Cooperation and the sub-licenses.

The Taxpayer contended that the BOR had failed to focus on the transactions that directly produced the profits, and instead emphasized on antecedent or incidental matters that were legally irrelevant.

Rejecting the Taxpayer's argument, the CFI noted that the fact that BLBG was designated as an agent under the Deed of Cooperation was irrelevant if BLBG's activities did not produce the Taxpayer's profit.

In this case, the Taxpayer had to perform its obligations under the Deed of Cooperation (that was, grant sub-licenses) to earn its profits, and that BLBG had to perform its obligations (that was, identify and introduce sub-licenses and arrange for negotiations) to earn its profits. The act which BLBG performed (identifying and introducing sub-licensees to the Taxpayer and arranging for negotiations) were not carried out on behalf of the Taxpayer in performance of the Taxpayer's obligations under the Deed of Cooperation, but rather, by BLBG in performance of its own obligations under the Deed of Cooperation.

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2. *Newfair Holdings Limited v CIR* [2022] HKCFI 1133
3. *ING Baring Securities Hong Kong Ltd v CIR* [2007] 10 HKCFAR 417

The CFI considered that it was 'putting the cart before the horse' to say that since BLBG was the Taxpayer's agent, therefore its activities should be attributed to the Taxpayer; the prior question was what were the profit producing activities of the Taxpayer? If such activities did not include what the "agent" did, then the fact that the "agent" was the Taxpayer's agent would be nothing to the point.

The CFI also did not consider that the BOR had applied the "brain analogy" or the place of administration of the business as criteria for ascertaining the geographical source of the profit.

The CFI noted that the BOR's consideration of the role of Antares Cheng as the ultimate decision maker of the Taxpayer was not made in the context of the general administration of the business of the Taxpayer but in the context of the Taxpayer's specific operations regarding the Deed of Cooperation and the sub-licenses. In this regard, the BOR rejected the Taxpayer's argument that those contracts were concluded by BLBG in Japan and that the execution of them by Antares Cheng in Hong Kong was a mere formality; the BOR held that those contracts were in fact concluded in Hong Kong.

As regards the Taxpayer's argument that the mere execution of those contracts was not by itself a profit-making operation and that what the Taxpayer did to earn its profits was to find potential Japanese sub-licensees and then negotiate and conclude contract with them through BLBG as its agent in Japan, the CFI however considered that the argument was not open to the Taxpayer. This was because this argument was contrary to the BOR's finding of fact that the sub-licensees were concluded in Hong Kong and the Taxpayer had not sought or obtained leave to challenge the finding.

The CFI also rejected the Taxpayer's argument based on the decision in *Lam Soon Trademark v CIR*[4]. The Taxpayer argued that since the judge in that case held that the taxpayer's profits were sourced in Hong Kong because the relevant agreements were concluded in Hong Kong, albeit signed elsewhere, it followed that in the present case, where the facts were reversed (with the relevant agreements being signed in Hong Kong but concluded elsewhere), the Taxpayer's profits must be sourced outside Hong Kong.

The CFI was however of the view that, leaving aside the incorrect factual premise of this argument (given that the BOR had held that the Deed of Cooperation and the sub-licenses were concluded in Hong Kong), the authority simply does not establish any proposition of law that a taxpayer's source of profits turns on where agreements are concluded and not where they are signed.

Citing Lord Jauncey's observation *in CIR v HK-TVB International*[5] that intellectual property rights exercisable only in one country are not to be equated with immovable property in that country, the CFI also rejected the Taxpayer's argument that since the Trademarks could only be exploited in Japan, profits from the sub-licensing could only be sourced in Japan.

Rejecting all the above major arguments of the Taxpayer, the CFI concluded that there was no merit in this ground of appeal.

Whether the Upfront Payment was a revenue or capital receipt

The Taxpayer's argument was that the Upfront Payment did not arise in the ordinary course of trade, having been paid prior to the commencement of the sublicensing business. Rather, it was a non-refundable payment made by BLBG to participate in the business and buy in to the Deed of Cooperation, and under the Deed of Cooperation, the Taxpayer parted with up to 60% of the economic benefit it would otherwise have derived under the Master License.

Relying on the case of *IRC v John Lewis*[6] where a lump sum payment received in consideration for the assignment of the rent receivable for five of the 21-year tenancy agreement of a property owner was held to be a capital receipt, the Taxpayer argued that the Upfront Payment for its parting with the 60% of the economic benefit it would otherwise have derived under the Master License should also be a capital receipt. Furthermore, the Upfront Payment was also made in connection with the permanent, profit-making structure of the Taxpayer's business in the form of the Master License.

The CFI however did not consider that the Taxpayer had transferred to BLBG 60% of the economic benefit it would otherwise have derived under the Master License in return for the Upfront Payment. Neither did the CFI consider that the Taxpayer suffered a temporary diminution in the value of its interests in the Master License to this extent in return for the Upfront Payment (unlike the taxpayer in *IRC v John Lewis* where the property owner suffered a temporary diminution in value of its property following its assignment of the rent receivable).

This was because the CFI considered that there was no factual basis for the assumption that the Taxpayer would have earnt the same amount in royalties with or without BLBG's participation (such that it can be concluded that with the BLBG's participation, the Taxpayer would have earned 60% less than it would have done without BLBG's participation). In any event, BLBG had to perform all its obligations under the Deed of Cooperation in order to earn its share of royalties, not just make the Upfront Payment.

The CFI also considered the fact of the case did not involve the Taxpayer receiving the Upfront Payment for the destruction or a material variation of its profit-making structure in the form of the Master License.

The CFI therefore upheld the BOR's decision that the Upfront Payment arose in the ordinary conduct of the Taxpayer's business. Looking the matter from a practical and business point of view of the Taxpayer as a recipient (notwithstanding the amount probably being a capital item from the payer's perspective), the Taxpayer received the Upfront Payment because it was in a position to exploit its rights under the Master License, not because it was giving up any asset or transferring any risk.

On the basis of the above, the CFI dismissed the Taxpayer's appeal.

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4. *Lam Soon Trademark v CIR* [2004] 3 HKLRD 258
5. *CIR v HK-TVB International* [1992] 2 HKLR 191
6. *IRC v John Lewis Properties plc* [2003] Ch 513

Commentary

This case indicates that to attribute the activities of an agent performed outside of Hong Kong to a taxpayer in Hong Kong for determining the source of the profits of the latter, the activities performed would have to be regarded as the profit-producing operations of the taxpayer in Hong Kong in the first place.

Taxpayers should note that such an attribution has so far only been made in certain limited factual context such as those in the *ING Baring*, *Li & Fung*[7] and *Hang Seng Bank*[8] cases (which all involved agency or sub-agency types of arrangements for executing a contract that directly led to generating profits on a transactional basis). As this case indicates, any attempt to extend the attribution to other more general circumstances such as where a joint-venture type of arrangement is involved would have to be made with caution.

In fact, the "principle of agency" argument may not even apply in the present case given the BOR's findings that the sub-licenses were concluded by the Taxpayer in Hong Kong and that the Taxpayer only recognized the 40% Royalties in its accounts as income without recognizing any agency fees to BLBG.

The case also lends support to the position adopted by the IRD in its Departmental Interpretation and Practice Notes No. 22 (Revised) in relation to the source rules for sub-licensing income, i.e., the source of such income would generally be determined by the place where the taxpayer obtained the rights and granted the sub-licensing rights (apparently based on the decision held in *CIR v TVB-Intentional*). An apportionment of the source of such income would apparently not be allowed.

Where such royalties received by a Hong Kong resident are regarded as sourced in Hong Kong as in this case and also regarded as sourced in the place overseas where the rights are used, the overseas tax paid would be creditable in Hong Kong if there is a tax treaty between Hong Kong and the overseas jurisdiction concerned. Otherwise, the overseas tax paid may be deductible in Hong Kong under section 16(1)(ca) of the Inland Revenue Ordinance.

Many of the issues involved in this case are complicated and clients should seek professional tax advice, where necessary.

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7. *CIR v Li & Fung (Trading) Ltd* [2011] HKCFI 261
8. *CIR v Hang Seng Bank* [1991] 1 AC 306

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