Hong Kong Tax Alert

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Court applies "principle of agency" in determining source of profit

In a recent judgment, the Court of Appeal[1] (CA) overturned a decision of the Court of First Instance[2] (CFI) and the Board of Review (BOR). The CA ruled that the CFI and the BOR made an error of law for failing to recognize the role played by an agent outside Hong Kong in the sub-licensing arrangements (with the master license being obtained in Hong Kong) in determining that the royalty income was wholly sourced in Hong Kong.

The CA however upheld the decision of the BOR and CFI that a contractual lump-sum payment received by the taxpayer was a taxable revenue item sourced in Hong Kong.

While the CA remitted the case to the BOR to reconsider the source issue based on its ruling of the "principle of agency" and the implications of the TVBI[3] case, the CA indicates that, based on the facts of the case, the source of the royalty income should be substantially offshore.

Depending on whether the Revenue would appeal against the CA's decision on the remitter, this CA's decision could open the door for an apportionment of at least royalty income derived from sub-licensing arrangements. Such an apportionment is apparently not currently envisaged by the practice notes issued by the Inland Revenue Department (IRD).

This alert discusses the issues involved in the case. Clients who wish to explore how the CA's decision could impact their existing or potential future offshore claims can contact their tax executives.

[1] The full CA decision can be retrieved from:

Patrick Cox Asia Limited v The Commissioner of Inland Revenue [2024] HKCA 944

[2] The full CFI decision can be retrieved from:

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

[3] *CIR v HK-TVB International Ltd* [1992] 2 AC 397

Facts

Patrick Cox Asia Limited (PCAL) (formerly called Hookedge Ltd) is a company incorporated in Hong Kong and is a wholly owned subsidiary of a company incorporated in the United Kingdom also called Hookedge Ltd (Hookedge). Mr. Antares Cheng (Cheng) was at all material times the sole director of PCAL.

Hookedge was the owner of the mark "Patrick Cox" and its related marks, logos and devices (the Trademarks).

It is common ground that the master license for the Trademarks was obtained by PCAL from Hookedge in Hong Kong.

PCAL was registered as the licensee of the Trademarks at, among others, the Japan Patent Office, with Hookedge being the registered owner.

Having obtained a master license and after some negotiation, on 21 January 2009 PCAL entered into an agreement by deed called "Deed of Cooperation" with a Japanese company called "British Luxury Brand Group Ltd" (BLBG) for the exploitation of the Trademarks in Japan.

Among other things, the Deed of Cooperation provided that:

(1) BLBG shall make an "upfront payment" of £500,000 to PCAL (Upfront Payment) upon the signing of the Deed as initial fee for obtaining the right to participate in the management of the business of the design, manufacture, distribution and sale of the products covered by the Trademarks in Japan (the Business) and the sharing of profits therefrom.

(2) subject to certain minimum payments of royalties guaranteed by BLBG to be received by PCAL, the royalty income received by PCAL from the Business shall be shared between PCAL and BLBG on a 40:60 basis during the relevant period.

Pursuant to the Deed of Cooperation, BLBG managed to procure three sub-licensing agreements that PCAL entered into with three Japanese sub-licenses between April and June 2009 (referred to below as "Sub-license Agreements" and "Sub-licensees" respectively).

Issue in dispute

The Commissioner of Inland Revenue (CIR) determined that the Upfront Payment of £500,000 received by PCAL and its 40% share of the royalty income totaling about HK$16.7 million for the years of assessment 2009/10 to 2012/13 were chargeable to tax in Hong Kong on the basis that they were Hong Kong sourced revenue income.

PCAL appealed against the CIR's determination to the BOR.

The royalties paid by the Sub-licensees collectively will be referred to below as the "Royalties" and the 40% portion received by PCAL as the "Royalties Income".

Decision of the BOR

The BOR disregarded the role played by BLBG and found that (i) PCAL obtained the master license in Hong Kong; (ii) PCAL was highly involved in the negotiation of the Deed of Cooperation in Hong Kong; (iii) PCAL had the final say on the appointment of the Sub-licensees and the terms of appointment; and (iv) both the Deed of Cooperation and the Sub-license Agreements were signed by the sole director of PCAL, Cheng in Hong Kong. The BOR also found that the Sub-license Agreements were concluded in Hong Kong.

The BOR considered that (i) what PCAL had done to earn the profits was the acquisition of the master license and the use of it in entering into the Deed of Cooperation and the Sub-license Agreements; and (ii) what BLBG did for procuring and negotiating of the Sub-license Agreements under the Deed of Cooperation were for its own benefit and therefore should be disregarded notwithstanding that BLBG acted as an agent of PCAL. The BOR supported its view on point (ii) above by referring to the fact that the accounts of PCAL only reflected 40% of the Royalties.

Thus, based on the facts found, the BOR held that the Upfront Payment and the Royalties Income were both taxable revenue items sourced in Hong Kong.

Dissatisfied, PCAL appealed against the BOR's decision ("Decision") to the CFI.

Decision of the CFI

The judge held that the BOR did not make any legal error, essentially endorsing the reasoning of the BOR's decision entirely. Thus, the CFI upheld the BOR's decision. Dissatisfied, PCAL appealed to the CA.

Decision of the CA

Source of Royalties Income - two flawed premises made by the BOR and CFI

The CA considered that the decision of the BOR and CFI were based on two flawed premises. The first is that the profits in respect of the Royalties Income were earned by PCAL from the performance of its obligations under the Deed of Cooperation. The CA took the view that the performance of the obligations under the Deed of Cooperation was only an antecedent, preparatory transaction incidental to the operations that generated the Royalties Income. As such, those obligations performed under the Deed of Cooperation should be disregarded in determining the source of the Royalties Income.

In addition, the CA also considered the BOR and CFI misdirected themselves in placing emphasis on the split of the Royalties that was governed by the Deed of Cooperation. The CA noted that under the Sub-license Agreements, the Royalties were payable to PCAL in their entirety. PCAL and BLBG agreed to divide them between themselves in the proportion of 40:60, but this does not affect the fact that PCAL received its own Royalties Income from the Sub-licensees (it being common ground that BLBG's guarantee in the Deed of Cooperation was not called upon). The 60% share is what PCAL was willing for BLBG to have in return for carrying out its duties to PCAL. It is unnecessary to know whether the money was first paid by the Sub-licensees to PCAL who then paid 60% to BLBG or the Sub-licensees were themselves directed to make split payments. Nor does it matter whether PCAL booked 100% of the Royalties as income and 60% as an expense, or simply booked 40% as income. In this regard, the CA cited *Nice Cheer*[4] as authority for saying that accounting treatment cannot dictate the assessment to tax.

The second false premise is that what BLBG did was done to earn its own profits and is therefore irrelevant to the geographic source of PCAL's profits. The CA noted that BLBG had to be paid as an agent. From BLBG's point of view, what it did was of course done for the purpose of earning its remuneration from its principal, PCAL. However, this alone does not prevent what BLBG did on behalf of PCAL from being regarded as PCAL's operations that earned the profits from the Sub-licensees, for the purposes of considering the source of PCAL's profits. In this regard, the CA quoted *ING Baring*[5] and *Li & Fung*[6] as authorities for saying that services performed by a paid agent on behalf of their principal can be attributed to the principal in determining the source of profits of the principal.

The CA also doubted the BOR's finding that the Sub-license Agreements were "concluded" by PCAL in Hong Kong, saying that to *"place the source of profit simply with the location of the decision-maker or where the contract was signed would be to run into fallacy"*.

Income-generating operations for the Royalties Income

As regards what were the income-generating operations for PCAL, the CA considered that they are principally threefold: first, the acquisition of the sub-licensing rights in respect of the Trademarks; secondly, the marketing of the Trademarks for sub-licensing and the negotiating and procuring of the Sub-license Agreements; and thirdly, the performance of the Sub-license Agreements including the provision of know-how, the maintenance of the Trademarks, the giving of requisite consent to the Sub-licensees for matters such as product design and retail prices, and potentially taking actions against infringement of the Trademarks by third parties.

In this regard, the CA cited *TVBI* and *Lam Soon*[7] as authorities for saying that acquisition of a licensing or sub-licensing right is a relevant operation for determining the source of royalty income.

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[4] *Nice Cheer Investment Ltd v CIR* [2013] 16 HKCFAR 813

[5] *ING Baring Securities (Hong Kong) Ltd v CIR* [2007] 10 HKCFAR 17

[6] *The CIR v Li & Fung (Trading) Ltd* [2012] 3 HKLRD 8

[7] *Lam Soon Trademark Ltd v CIR* [2004] 3 HKLRD 258

Significance of the TVBI case relevant to determining the source of the Royalties Income

PCAL argued that the Trademarks were territorial and were exercisable only in Japan as a matter of intellectual property (IP) law, thus rendering the source of the Royalties Income outside Hong Kong in Japan.

In this regard, the CA noted that the Privy Council qualified the statement made in the *TVBI* case that the territoriality of IP rights such as trademarks under the relevant IP laws is irrelevant to the source of profit by the condition: "*in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee*".

However, in this case PCAL did have financial interest in the subsequent exercise of the rights by the Sub-licensees given that PCAL's Royalties Income were based on a certain percentage of the sales value of the products covered by the Trademarks, albeit subject to certain minimum payments guaranteed by BLBG under the Deed of Cooperation.

CA remitted the case back to the BOR

Given the above views taken by the CA, the CA held that *"the Board erred in law in the determination of the source of PCAL's Royalties Income (1) by failing to take account of BLBG's activities in marketing the Trademarks, securing the Sub-licensees and procuring the Sub-license Agreements; (2) by failing to take account of BLBG's activities in servicing the Sub-license Agreements after they were entered into; (3) by failing to take into consideration that the Royalties were payable not on the grant of the sub-licensees but on the exercise of the licensed rights in Japan as a percentage of the Sub-licensees' sales (subject to the point about guaranteed minimum royalties); and (4) by taking into account the irrelevant fact that the Deed of Cooperation was negotiated by the taxpayer from Hong Kong and signed in Hong Kong, It follows that that part of the [BOR] Decision and the [CFI] Judgment must be set aside."*

"It does not, however, necessarily follow that PCAL's Royalties Income must in its entirety be regarded as having a source outside Hong Kong. There is after all the undisputed fact that the master license was acquired by PCAL in Hong Kong ...but as the court has not been addressed on the question of apportionment, as at present advised and assuming apportionment is open to the Board, we are not prepared to say the Board, proceeding on correct principles, would be traversing outside the range of tenable conclusions if it were to hold that a small part of the Royalties Income should on an apportionment be held as having arisen in or derived from Hong Kong. The source of profits is a question of fact."

Thus, the CA ordered a remitter on the source issue of the case to the BOR.

Upfront Payment – capital or revenue in nature

The CA rejected PCAL's argument based on *John Lewis Properties plc*[8] that the Upfront Payment was received in consideration of its transferring to BLBG a contingent right to income under the Deed of Cooperation, a right capable of subsisting as a capital asset.

Neither did the CA accept PCAL's argument that *"the Upfront Payment was made by BLBG to "buy-in" to a portion of PCAL's Japanese licensing business and act as the exclusive agent for PCAL in Japan...By the payment BLBG acquired an enduring interest in PCAL's only capital asset, i.e. the Trademark sub-licensing business as a whole."*

The CA took the view that while the Upfront Payment was not a yearly income, an arrangement of this kind for a mere 3.5 years (with the possible extension of 1.5 years) falls to be regarded as an ordinary incident of the trading operation of a firm.

Thus, the CA dismissed PCAL's argument on this issue.

[8] *IRC v John Lewis Properties plc* [2003] Ch 513

Commentary

If the CIR does not appeal against the CA's decision on the remitter, it appears that the BOR would be bound, based on the CA's ruling, to hold that the Royalties Income was substantially offshore income and not chargeable to tax in Hong Kong.

The CA's decision could therefore open the door for an apportionment of at least sub-licensing income, a possibility not apparently currently envisaged by the practice notes issued by the IRD.

In respect of a sub-licensing arrangement, the practice notes[9] only state that the place of acquiring and granting the license will be regarded as the source of royalty income. As such, the performance of the Sub-license Agreements and the implications of the *TVBI* case as found by the CA to be relevant income-generating operations in the case are not so envisaged in the practice notes.

Any appeal against the CA remitting the source issue of the case to the BOR may involve whether the CA is correct to hold that the performance of the obligations under the Deed of Cooperation is only an antecedent, preparatory transaction incidental to the operations that generated the Royalties Income.

Or whether the activities performed by a person under a joint-venture like cooperation agreement can be disregarded where under the agreement the person acts for their own benefit and in the process also acts as an agent for the other person, for determining the source of profit of the other person.

In addition, whether any charges of royalties based on turnover of the sub-licensee would necessarily constitute the licensor having a "financial interest in the subsequent exercise of the rights by the sub-licensee" may also be an issue.

As this case indicates, determining the source of income is complicated by nature. Clients who have any questions on how this CA's decision could impact their existing or potential future offshore claims can contact their tax executives.

[9] Paragraph 10 of Departmental Interpretation and Practice Notes No. 22 (Revised) refers.

Departmental Interpretation And Practice Notes - No. 22

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