News Flash
Hong Kong Tax

Court of Appeal refines source rules and suggests possibility of apportionment of royalty income

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In brief

On 17 October 2024, the Court of Appeal (CoA) handed down its judgment in *Patrick Cox Asia Limited* (Taxpayer) *v Commissioner of Inland Revenue* (Commissioner)[1]. The Taxpayer contended that royalties from sub-licensing trademarks to Japanese sub-licensees were offshore sourced. Under the arrangements, the Taxpayer entered into a cooperation agreement with a Japanese company, which was obliged to procure Japanese sub-licensees for the Taxpayer and act on its behalf in managing the Taxpayer's sub-licensing business in Japan. The Taxpayer received an upfront fee from the Japanese company upon signing of the cooperation agreement, as well as an annual royalty from the sub-licensees, which was split between the Taxpayer and the Japanese company.

The CoA held that:

- the upfront fee was sourced in Hong Kong and revenue in nature; and
- the Board of Review (Board) erred in its approach to determining the source of the annual royalty income by failing to consider the activities that directly produced the profits in question, consequently concluding incorrectly that the annual royalty income was sourced in Hong Kong.

As the determination of the source of the annual royalty income is a question of facts beyond the jurisdiction of the court, the CoA remitted the matter back to the Board for determination. This includes considering the possibility of apportionment in light of the CoA's judgment.

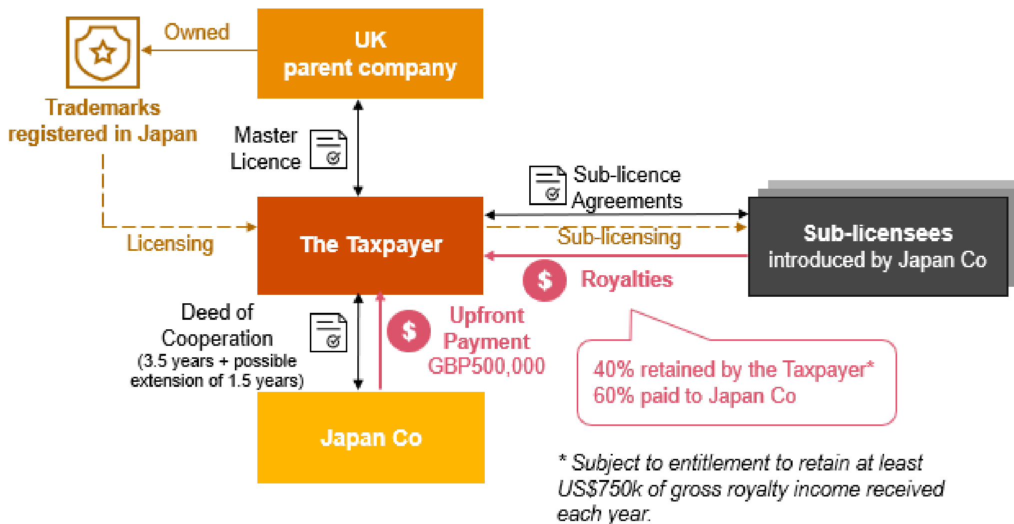
The CoA's decision is significant in several aspects. Firstly, it refined the general source rules for royalties from sub-licensing intellectual property (IP). When the amount of royalties received depends on the subsequent exploitation of the IP, the locality of the royalties is determined not only by the place of acquisition and granting of the license, but also by the location of the marketing of the IP for sub-licensing, the negotiation and procurement of the sub-licence agreements, as well as the performance of the sub-licence agreements. The decision also reaffirmed that under appropriate circumstances, the activities of another person performed outside Hong Kong can be attributed to the taxpayer to determine the source of profits, including royalties. Additionally, the CoA indicated the possibility of apportioning royalties, which has not previously been tested and was considered unwarranted under normal circumstances by the Inland Revenue Department (IRD).

Even though it is not yet known whether the Commissioner and/or the Taxpayer will further appeal the CoA's decision to the Court of Final Appeal (CFA), taxpayers engaged in sub-licensing arrangements should assess the potential implications of this case.

This news flash summarises the decisions of the CoA and our observations thereon.

In detail

Background of the case



- The Taxpayer is a Hong Kong company. Its parent company in the UK (UK parent company) was the owner of certain trademarks (Trademarks) and granted the Taxpayer a licence (Master Licence) to use the Trademarks, including the right to grant sub-licences to third parties in the Asia Pacific Region.

- The Taxpayer entered into an agreement (Deed of Cooperation) with a Japanese company (Japan Co), under which Japan Co was authorised to represent the Taxpayer's group and brand in Japan. Additionally, The Taxpayer also delegated the day-to-day running of its business of design, manufacture, distribution and sale of certain products under the Trademarks in Japan to Japan Co. The Taxpayer generally followed Japan Co's recommendations regarding the appointment of licensees and their terms, and any sub-licensing agreement procured by Japan Co was to be executed directly between the Taxpayer or one of its group members and each licensee, ensuring that all royalty income would flow to the Taxpayer.

- Upon signing of the Deed of Cooperation, Japan Co made an upfront payment of GBP500,000 (Upfront Payment) to the Taxpayer as an initial fee for obtaining (i) the right to participate in the management of the Taxpayer's business and (ii) the sharing of profits therefrom (i.e. the gross amount of the royalties).

- The Deed of Cooperation further provided that any royalty income received by the Taxpayer was to be shared between the Taxpayer and Japan Co in the ratio of 40:60, subject to the Taxpayer's entitlement to retain at least US$750,000 of the gross royalty income received each year.

- During the relevant period, Japan Co secured three sub-licensing agreements for the Taxpayer with three Japanese sub-licensees (Sub-licence Agreements and Sub-licensees). While Japan Co was not a party to these agreements, it was recited that Japan Co was appointed by the Taxpayer as its agent performing the functions of the Taxpayer's representative in Japan.

- Pursuant to the Sub-licence Agreements, the terms of which were very similar, the Taxpayer (i) granted the Sub-licensee exclusive rights to manufacture and sell products in Japan using the Trademarks; (ii) provided necessary protection for the Trademarks and the know-how for manufacturing and selling the products; and (iii) required the Sub-licensee to obtain its prior consent (or through Japan Co) for various matters concerning product manufacturing and retail pricing.

- In return, the Sub-licensees paid the Taxpayer royalties calculated as a percentage of the Sub-licensees' sales or net turnover. Two of the Sub-licence Agreements contain provisions on the minimum amounts of royalties payable to the Taxpayer.

- Between 2009 and 2013, the Taxpayer received royalties from the Sub-licensees, 40% of which was retained by the Taxpayer as its income (40% Royalties), with the other 60% going to Japan Co. The royalty income derived by the

Taxpayer over the four years totalled HK$16.67 million, which comprised solely the 40% Royalties from the Sub-licensees, and Japan Co's guarantee in the Deed of Cooperation was never called upon.

- The issue in dispute before the CoA was whether the 40% Royalties and the Upfront Payment accrued in the four years of assessment from 2009/10 to 2012/13 were chargeable to profits tax under section 14 of the Inland Revenue Ordinance (IRO)[2].

The CoA's judgment

Issue 1 – Source of the 40% Royalties

- The CoA found that the Board and the Court of First Instance (CFI) made two critical errors in determining the source of the 40% Royalties. Firstly, the Board and the CFI incorrectly concluded that the Taxpayer's profit-producing activities were limited to the acquisition of the Trademarks for sub-licensing under the Master Licence and the entering into of the Deed of Cooperation and Sub-licence Agreements.

- The CoA pointed out that the 40% Royalties were paid by the Sub-licensees on the exercise of the rights in the Trademarks in Japan as a percentage of the Sub-licensees' sales (subject to a guaranteed minimum royalty) under the Sub-licence Agreements. The focus should have been on what the Taxpayer did to earn the 40% Royalties from the Sub-licensees. The method of payment (i.e. whether the Sub-licensees paid the Taxpayer first or made split payments directly) and the accounting treatment were irrelevant in determining the source of the 40% Royalties.

- The second false premise was that Japan Co's activities performed pursuant to the Deed of Cooperation were to earn its own profits and were irrelevant to the geographical source of the Taxpayer's profits. The CoA reasoned that Japan Co was not a gratuitous agent and logically had to be remunerated for fulfilling its obligations under the Deed of Cooperation. However, this alone did not prevent what Japan Co did on behalf of the Taxpayer from being considered as the Taxpayer's profit-producing activities for determining the source of the 40% Royalties.

- In the CoA's view, the direct profit-producing activities leading to the 40% Royalties were: (i) acquisition of the Trademarks for sub-licensing; (ii) marketing of the Trademarks for sub-licensing, as well as the negotiation and procurement of the Sub-licence Agreements; and (iii) performance of the Sub-licence Agreements.

- The Deed of Cooperation, which was regarded by the Board and the CFI as part of the profit-producing activities undertaken to earn the 40% Royalties, was found by the CoA to be an antecedent, preparatory transaction incidental to the operations that generated the 40% Royalties. While the Deed of Cooperation was commercially significant, case law principles require that in determining the source of profits, one should focus on the direct profit-producing activities, rather than various other antecedent or incidental business activities.

- Based on the apparent facts, the marketing of the Trademarks for sub-licensing, as well as the negotiation and procurement of the Sub-licence Agreements, were carried out by Japan Co on behalf of the Taxpayer in Japan. According to case law precedents, the profit-producing activities do not have to be performed by an entity which is the taxpayer's agent in the full legal sense before those activities can be attributed to the taxpayer. It is sufficient that the activities were carried out on the taxpayer's behalf and for its account under the taxpayer's instructions. Following this attribution rule, the CoA determined that these activities should be attributed to the Taxpayer.

- Furthermore, the CoA considered that the performance of the Sub-licence Agreements, which included the provision of know-how, maintenance of the Trademarks, and other ongoing obligations under the Sub-license Agreements, was essential for the generation of the 40% Royalties. As the Taxpayer had engaged Japan Co to fulfil its post-grant obligations under the Sub-licence Agreements, the performance of these activities by Japan Co in Japan should likewise be attributed to the Taxpayer in determining the source of the 40% Royalties.

- The CoA, however, rejected the Taxpayer's proposition that the 40% Royalties, which arose from the exploitation of the Trademarks, should be sourced in the jurisdiction where they are registered (i.e. Japan). The CoA, while agreeing that trademarks were territorial and the Trademarks in this case were exercisable only in Japan, stated that this did not necessarily mean that the profits derived were sourced from Japan. The Privy Council decision in *Commissioner of Inland Revenue v HK-TVB International Ltd* [1992] 2 AC 397 (*TVBI* case) indicated that the territoriality of IP rights is irrelevant to the source of profits, on the premise that the royalties in question were fixed outright payments and the

taxpayer had no financial interest in the subsequent exercise of the rights by the sub-licensees. The CoA noted that in the present case, while the Taxpayer did have a continuing financial interest in the exercise of the rights in the Trademarks, two of the three Sub-license Agreements included minimum guaranteed payments, which undermined the argument that the territorial registration of the Trademarks alone dictates the source of the income.

Conclusions

- The CoA noted that while the second and third sets of profit-producing activities were undertaken by Japan Co on behalf of the Taxpayer outside Hong Kong, there was no dispute that the first set of profit-producing activities, namely the acquisition of the Trademarks for sub-licensing under the Master Licence, was undertaken in Hong Kong. As such, it did not necessarily follow that the 40% Royalties were entirely offshore sourced.

- As the source of profits is a factual question and the court's jurisdiction to review the Board's decision is limited to questions of law, the CoA remitted the matter back to the Board to make the necessary determination in light of its judgment.

Our observations: *This CoA's decision is significant in the following aspects:*

Refining the source rules for royalties derived from sub-licensing of IP: *The IRD indicated in its Departmental Interpretation and Practice Notes (DIPN) No. 22 that, the place of acquisition and granting of the license generally determines the source of royalties derived from sub-licensing of IP. However, the CoA has refined this rule, holding that if royalties are received based on the exploitation of IP assets (e.g. sub-licensees' sales), the location of the marketing of the IP for sub-licensing, and the negotiation and procurement of the sub-licence agreements, should also be considered.*

Despite the general guidance in DIPN No. 22, the IRD has increasingly focused on the place of development, enhancement, maintenance, protection and exploitation (commonly known as 'DEMPE' functions) of the relevant IP in determining the source of royalty income. This focus is largely consistent with the CoA's emphasis on the performance of contracts. Given the CoA's decision, the IRD may also emphasise these operations in its future assessments of offshore claims made with respect to royalties.

Regarding the relevance of the place of registration of trademarks, it is worth mentioning that in another Board decision concerning, inter alia, the source of royalty income from acquired trademarks[3], the Board considered that the TVBI *case was not directly relevant, as trademarks, unlike copyrights in the* TVBI *case, require registration and have territorial limitations. The Board thus gave preference to the place of registration and maintenance of the trademarks over other factors such as the place of contract, noting that the maintenance, without which the value of the trademarks is bound to depreciate, is sufficiently proximate to the exploitation of those trademarks for profit. While the CoA in the present case rejected the Taxpayer's contention that the place of registration was a relevant profit-producing activity, this rejection was based on the specific facts of the case, where some Sub-licence Agreements included guaranteed minimum royalties. The Taxpayer's contention could perhaps be accepted if there was evidence to support that the entire 40% Royalties were solely based on a percentage of the Sub-licensees' sales.*

Reaffirming the application of the attribution rule: *The attribution rule was first enunciated in the CFA's decision in* ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue *[2007] 10 HKCFAR 17, which involved the determination of the source of brokerage commission income. Initially, the IRD attempted to confine the application of this rule strictly to brokerage commission income. However, this restrictive view was challenged in another case concerning the source of agency commission income. This CoA decision provides a welcoming reaffirmation that under appropriate circumstances, the attribution rule can be applied to various types of income, including royalties.*

Indicating the possibility of apportioning royalty income: *DIPN No. 22 is silent on the apportionment of royalties, and the IRD previously indicated that the apportionment of royalties would not normally be warranted[4]. However, there are views suggesting that, based on a dictum in a Privy Council decision, profits could be apportioned in the absence of explicit provisions in the IRO prohibiting apportionment. Although this decision was not directly related to royalties, it implied that apportionment might be permissible. Nonetheless, the final resolution of this issue depends on whether the Commissioner decides to appeal to the CFA for a definitive ruling. As of the date of publication of this news flash, it is not yet known whether the Commissioner will further appeal the CoA's decision on this issue to the CFA. However, it is likely the Commissioner will pursue this course of action given the implications.*

Issue 2 – Taxability of the Upfront Payment

Source of the Upfront Payment

- The CoA considered it necessary to analyse the source of the Upfront Payment and the 40% Royalties separately. Nonetheless, it agreed with the Board and the CFI that the profit-producing activities leading to the Upfront Payment were the acquisition of the Trademarks for sub-licensing under the Master Licence and the entering into of the Deed of Cooperation.

- Unlike the 40% Royalties, the Upfront Payment was received from Japan Co under the Deed of Cooperation before the sub-licensing business commenced. As such, what Japan Co is said to have done on behalf of the Taxpayer in managing the sub-licensing business cannot sensibly be regarded as the Taxpayer's operations that earned the Upfront Payment.

- The Upfront Payment was in substance a payment made by Japan Co to the Taxpayer under the Deed of Cooperation. This payment was for appointing Japan Co as the Taxpayer's agent and delegating the management of the sub-licensing business to Japan Co. Where the Trademarks were registered and exploited was irrelevant in determining the source of the Upfront Payment.

- The CoA also rejected the Taxpayer's claim that the acquisition of the rights in the Trademarks under the Master Licence should be disregarded solely because the agreement was unilaterally conferred. Relying on the *TVBI* case, the CoA noted that the acquisition of the sub-licensing rights, even without effort, constituted a profit-producing transaction for the taxpayer. Furthermore, the CoA observed that the Taxpayer paid licence fees to the UK parent company under the Master Licence, indicating that the Taxpayer was not just a passive recipient of the sub-licensing rights.

- Since both the Master License and the Deed of Cooperation were negotiated and concluded by the Taxpayer in Hong Kong, the CoA upheld the Board's view that the Upfront Payment was sourced in Hong Kong.

Whether the Upfront Payment is a capital receipt

The CoA applied the principles established in case law precedents and made the following observations:

- While the Upfront Payment is a one-off income, the term under the Deed of Cooperation was only three and a half years (with a possible extension of one and a half years). Such an arrangement cannot be regarded a 'permanent' structure of the Taxpayer's profit-making operations or as giving Japan Co an 'enduring' interest in the Trademarks.

- The Taxpayer received the Upfront Payment for exploiting its rights in the Trademarks through cooperating with Japan Co as part of its ordinary course of business, not for disposing of its capital asset or transferring its business to Japan Co.

- While risk allocation is involved in the Upfront Payment whereby the Taxpayer was protected from the counterparty risk of Japan Co, this is not determinative of the Upfront Payment's nature.

- The Taxpayer submitted that the Deed of Cooperation caused a temporary diminution in the value of its interest in the Master Licence. In view of Japan Co's guarantee of the Taxpayer's minimum royalties and the benefits brought by its expertise and services in promoting the Trademarks and securing the sub-licensing arrangements, the CoA considered the Taxpayer's submission to be a mere assertion without evidence.

Based on the above, the CoA upheld the Board's view that the Upfront Payment was revenue in nature.

Our observations: *While the CoA noted that a payment which is a capital expenditure for the payer is not necessarily a capital receipt in the hands of the payee, it contended that the exercise in determining the nature of a payment, whether a receipt or expenditure, is sufficiently similar for the cases on one exercise to provide guidance for the other. In analysing the nature of the Upfront Payment in the present case and concluding that it was revenue, the CoA made reference to various cases in relation to expenditure. Subject to any appeal to be made by the Taxpayer on this issue, thoughts may be given as to how this decision may impact the determination of the nature of an upfront payment that is an expenditure. Under the*

current practice, the IRD regards all upfront payments as capital in nature in the hands of the payer, as noted in the DIPN No. 49, creating a disparity in treatment between the payer and payee (where both are Hong Kong taxpayers).

The takeaway

The decision highlights the complexity of tax disputes, especially in identifying the geographical location of profit-producing transactions, distinct from antecedent or incidental activities. Furthermore, this decision introduces the potential for apportioning royalties, which could significantly impact previously infeasible offshore claims.

Nevertheless, under the foreign-sourced income exemption regime, offshore-sourced royalty income is deemed to be sourced in Hong Kong and subject to profits tax if it represents IP income accrued to and received in Hong Kong by a multinational enterprise entity carrying on a business in Hong Kong on or after 1 January 2023 (regardless of nature), unless the nexus requirement is met. As pointed out in our prior news flashes, meeting the nexus requirement (including the need for the IP income to be derived from qualifying IP which does not encompass trademarks) for offshore IP income is a practical challenge.

Given the complexity of these issues, taxpayers are strongly encouraged to seek professional advice to fully understand the implications of this CoA decision on their current licensing arrangements. We will continue to closely monitor the situation, including any further appeal to be lodged by the Commissioner and/or the Taxpayer, and keep you informed of any further developments or implications that may arise.

Endnotes

1. The CoA's judgment can be accessed via this link:
https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=163517&currpage=T

2. There was an additional ground previously relied on by the Taxpayer, namely that it did not carry on a trade, profession or business in Hong Kong. However, this was rejected by both the Board and the CFI and was no longer pursued in the appeal before the CoA.

3. Board's decision D7/19, which can be accessed via this link:
https://www.info.gov.hk/bor/en/decisions/docs/D719.pdf

4. Agenda item A1(l)(i) of the 2013 annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants, which can be accessed via this link:
https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section5_membership/Professional-Representation/pdf-file/tax-b/24.pdf

Let's talk

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