KPMG

Hong Kong (SAR) Tax Alert

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The Court of Appeal discussed the source and apportionment of trademark sub-licensing income in a recent case

Summary

The Court of Appeal (CA) handed down its judgment on *Patrick Cox Asia Limited v Commissioner of Inland Revenue*[1] on 17 October 2024.

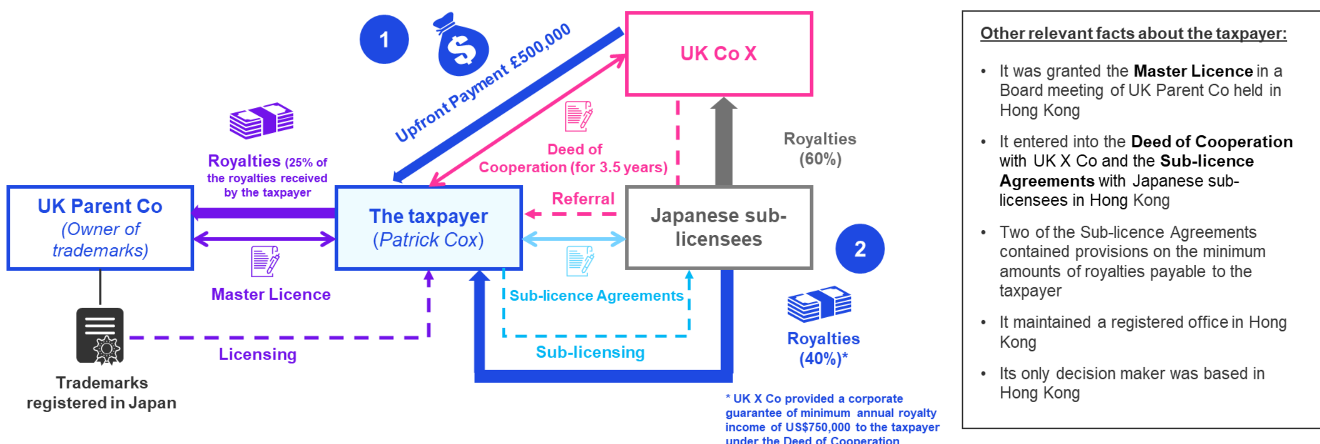
The CA upheld the Board of Review (Board)'s decision that the upfront payment received by the taxpayer under a trademark sub-licensing arrangement is revenue in nature and Hong Kong sourced. However, the CA ruled that the Board erred in law in determining that the royalty income derived by the taxpayer under the same sub-licensing arrangement was sourced in the Hong Kong SAR (Hong Kong). The CA therefore remitted the case back to the Board for a rehearing on this issue.

In this tax alert, we summarise the CA's judgment and share our observations on the case.

Background

The taxpayer is a Hong Kong-incorporated company engaged in licensing and sub-licensing of trademarks. It licensed the trademarks from its UK parent company and sub-licensed them to the Japanese companies introduced by another UK company (UK Co X). Under the Deed of Cooperation between the taxpayer and UK Co X, UK Co X made an upfront payment to the taxpayer for (1) obtaining the exclusive right to participate in and manage the business of selling certain products under the trademarks in Japan and (2) sharing the profits (i.e. 60% of the royalties received from the Japanese sub-licensees) derived from such business.

The diagram below provides an overview of the taxpayer's business model and the income streams involved.



[1] The CA judgment can be accessed via this link: legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=163517&QS=%24%28patrick%2Bcox%29&TP=JU

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The Court of First Instance (CFI) upheld the Board's decision that both the Upfront Payment and the 40% royalties (Royalties Income) received by the taxpayer were revenue in nature and sourced in Hong Kong[2]. The taxpayer then lodged a further appeal to the CA.

The issues in dispute

The key question in the case is whether the Upfront Payment and Royalties Income derived by the taxpayer are taxable. In answering this question, the key issues in dispute are: (1) whether the Upfront Payment was sourced from Hong Kong, (2) whether the Royalties Income was sourced from Hong Kong and (3) whether the Upfront Payment was capital or revenue in nature.

The CA's judgment and analyses

Below is a summary of the CA's judgment and analyses on the above issues.

Issue 1: What is the source of the Upfront Payment?

- The CA agreed with the Board that the profit-producing activities in respect of the Upfront Payment were (1) the acquisition of the Master Licence and (2) the entering into of the Deed of Cooperation.
- As the Upfront Payment was received under the Deed of Cooperation from UK Co X and before the sub-licensing business commenced, the activities performed by UK Co X on behalf of the taxpayer in Japan in managing the sub-licensing business are not the relevant activities that produced the Upfront Payment.
- As both the Master Licence and Deed of Cooperation were negotiated and/or concluded in Hong Kong, the CA ruled that the Upfront Payment was sourced in Hong Kong and dismissed the taxpayer's appeal on this issue.

Issue 2: What is the source of the Royalties Income?

- Both the CFI and the Board concluded that the taxpayer derived the Royalties Income from (1) acquiring the Master Licence from the UK parent company and (2) entering into the Deed of Cooperation and Sub-licence Agreements. Neither of them took into account the activities performed by UK Co X on behalf of the taxpayer in Japan under the Sub-licence Agreements in determining the source of the Royalties Income.
- The CA, however, noted that the entire (i.e. 100%) royalties were payable by the sub-licensees to the taxpayer under the Sub-licence Agreements (rather than the Deed of Cooperation). The entering into of the Deed of Cooperation was therefore an antecedent/preparatory transaction incidental to the profits-producing activities and irrelevant to determining the source of the Royalties Income.
- The profit-producing activities in respect of the Royalties Income should be:
    1. acquiring the sub-licensing rights from the UK parent company under the Master License;
    2. marketing of the trademarks for sub-licensing;
    3. identifying potential sub-licensees, negotiating and procuring the execution of the Sub-licence Agreements; and
    4. performing the post-grant obligations under Sub-licence Agreements (e.g. provision of know-how, maintenance of the trademarks and day-to-day running of the licensing business, etc.).
- UK Co X performed the activities in (2) to (4) above for and on behalf of the taxpayer in Japan as part of its duties to the taxpayer under the Deed of Cooperation.
- The ING Baring case[3] established that in considering the source of profits, it is not necessary to show that the profit-producing transaction was carried out by the taxpayer's agent in the full legal sense. It is sufficient that it was carried out on the taxpayer's behalf and for his account by a person acting on his instructions. In addition, the Sub-licence Agreements expressively stated that UK Co X was appointed by the taxpayer as its agent in performing the functions of the licensor under the Sub-licence Agreements.
- UK X Co was therefore an agent of the taxpayer and its activities in Japan were attributed to the taxpayer as its activities for producing the Royalties Income.

[2] For previous coverage of the case and the CFI's judgment, please refer to our Hong Kong (SAR) Tax Alert - Issue 24, December 2023.
[3] For more details of the case, please refer to this link: legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=58711&QS=%24%28ing%2Cbaring%29&TP=JU

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- Although the rights conferred by the trademarks were territorial and such rights were exercisable only in Japan, it does not necessarily follow that the Royalties Income was sourced from Japan. It depends on whether the taxpayer had any financial interest in the subsequent exercise of the rights by the sub-licensees[4]. In this case, even though the Royalties Income were computed as a percentage of the sub-licensees' sales in Japan (i.e. the taxpayer had a continuing financial interest in the exercise of the rights in Japan), the fact that there was a guaranteed minimum amount of royalties under two out of the three Sub-licence Agreements and that the extent to which the Royalties Income was constituted by these fixed payments is unclear from the evidence had largely reduced the relevancy of the location where the trademarks were exploited in determining the source of the Royalties Income.

- Based on the above, the CA ruled that the Board erred in determining that the Royalties Income was sourced from Hong Kong. However, it does not necessarily follow that the Royalties Income must in its entirety be regarded as sourced outside Hong Kong. As it is not in dispute that the Master Licence was acquired by the taxpayer in Hong Kong, assuming apportionment is open to the Board, it would not be an untenable conclusion if the Board were to hold that a small part of the Royalties Income should be sourced in Hong Kong. As the source of profits is a question of facts to be determined by the Board, the CA remitted the case back to the Board for a rehearing on the sourcing issue.

Issue 3: Whether the Upfront Payment was capital in nature?

- Although the Upfront Payment was not a yearly income, an arrangement of the kind between the taxpayer and UK Co X for a mere 3.5 years is regarded as an ordinary incident of the taxpayer's trading operation.
- The taxpayer did not give up any capital assets. It is not accurate to view the Upfront payment as (1) the price of sale of a pre-existing right to receive 60% of the royalties or (2) consideration for transferring the taxpayer's rights under the Master Licence or the Deed of Cooperation.
- There was also no transfer of risk. UK X Co's guarantee of minimum annual royalty income for the taxpayer represented an allocation of market risks and the Upfront Payment protected the taxpayer from the counterparty risk of UK X Co defaulting.
- The taxpayer's argument that there was a diminution in the value of the Master Licence because it was impaired by the Deed of Cooperation is only a mere assertion without evidential basis. In fact, the Deed of Cooperation gave the taxpayer the benefits of guaranteed royalty income as well as the expertise and services of UK X Co.

Based on the above, the CA dismissed the taxpayer's appeal and held that the Upfront Payment was revenue in nature.

KPMG Observations

Subject to any further appeal and the final outcome of the case, the CA judgment raised a number of noteworthy issues relating to the taxation of royalties from sub-licensing of intangible assets as discussed below.

The source rules for royalty income

The existing case law[5] in Hong Kong and the Inland Revenue Department (IRD)'s assessing practice as stated in Departmental Interpretation and Practice Notes (DIPN) No. 22[6] regard the source of royalty income from licensing and sub-licensing of intangible assets as the place(s) where the licensing and sub-licensing agreements are effected.

However, the CA in this case considered that the post-grant activities performed in connection with the execution and maintenance of the Sub-licence Agreements (e.g. promotion and maintenance of the trademarks, provision of know-how and the day-to-day operation of the sub-licensing business) after the agreements were concluded are also the relevant profit-producing activities.

This could be due the specific fact pattern of this case where (1) the amount of royalties derived by the taxpayer would depend on the sub-licensees' sales amounts (instead of being a fixed amount) and (2) the taxpayer (through UK X Co) provided various support to the sub-licensees on the design, manufacturing, promotion and sale of the products after the sub-licences were granted. Potentially, the Royalties Income derived by the taxpayer could be viewed as consisting of income from granting of the trademarks and income from provision of services to facilitate sales of the products in Japan.

The CA judgment also states that the Board erred by, among other things, failing to take into consideration that the royalties were payable not on the grant of the sub-licences but only 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). This implies that the location of use of the intangible asset will carry more weight in determining the source of the royalty income in other cases when the licensor has a continuing financial interest in the subsequent exercise of the rights in exploiting the asset in that location.

[4] In CIR v HK-TVB International Ltd, the Privy Council held that the territoriality of the film rights granted by the taxpayer is irrelevant to the source of its profits but it was based on the condition of "in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee".
[5] The CIR v HK-TVB International Ltd and Lam Soon Trademark Ltd v CIR cases
[6] The DIPN No. 22 can be accessed via this link: https://www.ird.gov.hk/eng/pdf/dipn22.pdf

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Apportionment between onshore and offshore royalty income

As pointed out in our previous tax alert on this case, although DIPN No. 22 is silent on whether there could be an apportionment between onshore and offshore sourced royalty income and there have not been any precedent cases specifically dealing with this issue so far, we consider that in cases where the activities for producing the royalty incomeare performed both in and outside Hong Kong, apportionment of the royalty income should be considered. It is encouraging to see that in its judgment, the CA does consider that apportionment of royalty income is tenable under the law despite further consideration is required on whether the appointment issue is open to the Board in this particular case. The final outcome of this case may set a precedent in Hong Kong on apportionment of royalty income and provide greater clarity to taxpayers on taxation of royalties from sub-licensing of intangible assets.

Impact of the FSIE regime on foreign-sourced income related to intellectual property (IP)

As mentioned in our previous tax alert on this case, royalty income and capital receipts from sale of IP that are foreign-sourced may nevertheless be taxable under the Foreign-Sourced Income Exemption (FSIE) regime in Hong Kong if they are received in Hong Kong and the specified conditions are not met. Business groups in Hong Kong deriving income from IP should carefully assess the respective profits tax implications of onshore and offshore IP income and consider how best to structure the IP licensing arrangement.

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