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Hong Kong Tax Analysis

A recent Court of Appeal case ruling on the taxability of royalties and upfront payment

Hong Kong's Court of Appeal (CA) recently released its decision on *Patrick Cox Asia Limited v. The Commissioner of Inland Revenue [2024 HKCA 944]*, regarding the taxability of an upfront payment received under a business cooperation arrangement and royalties arising from a sub-licensing arrangement. In its judgment, the CA held that the upfront payment received was not capital in nature and was sourced in Hong Kong as the relevant agreements were concluded in Hong Kong, hence subject to taxation. For the royalty income under the sub-licensing arrangement, the CA rejected the Board of Review (BoR)'s decision that it was entirely onshore-sourced on the grounds that the royalties were derived from activities both in and outside Hong Kong. The CA remitted the issue back to the BoR for further consideration as to whether only a small part of the royalties would be onshore-sourced, based on an apportionment approach.

In this article, we summarize the facts of the case and highlight the reasoning behind the judgment.

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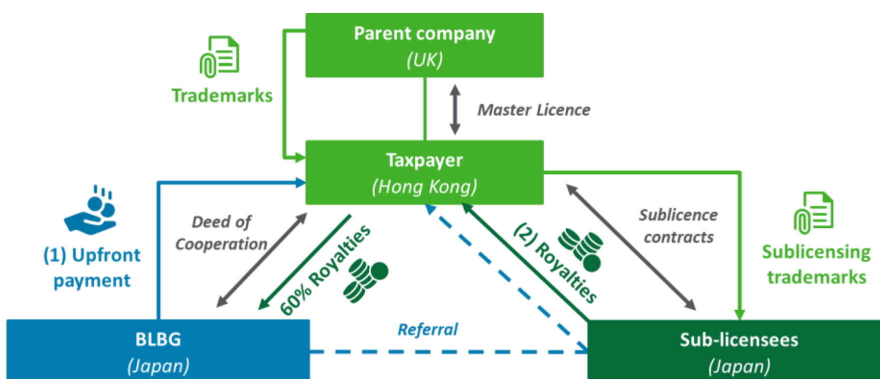
Background



- The taxpayer was incorporated in Hong Kong and was engaged in sub-licensing trademarks.
- It obtained trademarks from its UK parent company under a Master Licence, and sub-licenced them to Japanese companies solicited by a Japanese agent, British Luxury Brand Group Ltd (BLBG).

- The taxpayer entered into a Deed of Cooperation with BLBG, which included the following provisions:
  (1) BLBG made an upfront payment of GBP500,000 to the taxpayer for the right to participate in the sub-licensing business.
  (2) BLBG was appointed as the taxpayer's agent to manage the sub-licensing business in Japan, including negotiating sub-licence agreements on behalf of the taxpayer.
  (3) Royalty income received from the sub-licensees by the taxpayer was to be shared between the taxpayer and BLBG in a ratio of 40:60.
  (4) BLBG provided a corporate guarantee of minimum royalty income to be received by the taxpayer.
- The taxpayer maintained an office in Hong Kong and conducted various business operations there, including the signing of the Deed of Cooperation and sub-licence agreements with various Japanese sub-licensees. The Master Licence was also acquired by the taxpayer in Hong Kong.

The taxpayer claimed that the upfront payment and the royalties were non-taxable on the grounds that they were offshore-sourced, and in addition the upfront payment was capital in nature. However, the Inland Revenue Department (IRD) disagreed and treated both the upfront payment and the royalties as taxable.

Dispute

The key issues in dispute were:

Issue 1 – Whether the upfront payment was a capital receipt.

Issue 2 – Whether the upfront payment was arising in or derived from Hong Kong.

Issue 3 – Whether the royalties were arising in or derived from Hong Kong.

Decision

Both the BoR and Court of First Instance (CFI) ruled in favour of the IRD, concluding that the upfront payment and the royalties were taxable. The CA upheld the BoR's and CFI's decisions concerning the taxability of the upfront payment but partially allowed the taxpayer's appeal regarding the source of the royalties. The grounds of the CA's decisions are summarized below.

Upfront payment

(i) Capital or revenue receipt

The taxpayer contended that the upfront payment was a lump sum payment made by BLBG to acquire an enduring interest in the taxpayer's sub-licensing business, which was a permanent profit-making apparatus. The payment was for transferring BLBG a contingent right to income, which could be considered a capital asset. Furthermore, there was a transfer of risk from the taxpayer to BLBG, as BLBG guaranteed the taxpayer a minimum amount of royalty income, which suggested the transfer as capital in nature. The taxpayer also pointed to a temporary diminution in the value of the Master Licence as evidence of a capital transfer.

However, the CA held that the upfront payment was revenue in nature for the following major grounds:

- Short duration – The CA considered that the cooperation arrangement for a mere 3.5 years, with a conditional option to renew for another 1.5 years, would be regarded as an ordinary incident of trading operations and could not be regarded as a permanent structure of profit-making operations.

- **No disposal of capital asset nor transfer of business** – The CA considered that the taxpayer received the upfront payment because it decided to exploit its rights in the trademarks through cooperation with BLBG, not because it was disposing of the whole or any part of its capital asset or transferring its business to BLBG.

- **No transfer of risk** – The CA considered that the payment structure of the Deed of Cooperation (divided into an upfront payment and guaranteed payment of royalties) was for allocation of risk, and the upfront payment was akin to an advance payment.

- **No diminution in value of asset** – There was no evidence of a temporary diminution in the value of the Master Licence which might suggest a transfer.

(ii) Source of upfront payment

The CA analysed the source of the upfront payment and that of the royalties separately, although the taxpayer did not submit separate arguments. It considered that what the taxpayer did to earn the upfront payment was the acquisition of the Master Licence from its UK parent company, and the use of such a licence to enter into the Deed of Cooperation. As both the Master Licence and Deed of Cooperation were concluded in Hong Kong, the CA held that the upfront payment was sourced in Hong Kong.

Source of royalties

The taxpayer contended that BLBG was its agent, and accordingly, BLBG's operations in Japan should be imputed to the taxpayer. Although the Deed of Cooperation and the sub-licence agreements were signed in Hong Kong, they were effected in Japan by BLBG on behalf of the taxpayer. In addition, the grant of Master Licence by the UK parent company to the taxpayer was not a profit-making operation for the taxpayer, as it did nothing to obtain it and got nothing from it unless it engaged in sub-licensing operations. The taxpayer also contended that the trademarks were registered in Japan and could only be exploited there, thus the royalty income should be sourced outside Hong Kong.

The lower courts considered that BLBG's activities were irrelevant as they did not produce the taxpayer's 40% royalties but rather BLBG's own 60% royalties.

However, the CA disagreed. It considered that the gross royalties were earned by the taxpayer under the sub-licence agreements and therefore it should look at what was done under the sub-licence agreements. It was a false premise to ignore BLBG's activities carried out on behalf of the taxpayer in determining the source of the taxpayer's income. Whether BLBG was paid a fixed fee or a percentage of royalty was irrelevant. It did not matter whether the taxpayer booked the entire gross royalties as income and 60% as an expense, or simply booked 40% as income. The relevant profit-producing activities taken into account by the CA were:

(1) the acquisition of sub-licensing rights in respect of the trademarks (*conducted by the taxpayer in Hong Kong*);

(2) the marketing of the trademarks for sub-licensing, and the negotiating and procuring of sub-licence agreements (*conducted by BLBG in Japan*); and

(3) the performance of the sub-licence agreements, including the provision of know-how, the maintenance of the trademarks, the giving of requisite consent to matters such as product design and retail prices, and potentially taking actions against infringement of the trademarks (*conducted by BLBG in Japan*).

As the profit-producing activities were partly conducted in Hong Kong and partly outside Hong Kong, the CA rejected the BoR's decision that the entire royalty income was onshore-sourced. It left open the possibility that a small part of the royalties on an apportionment basis could be sourced in Hong Kong and remitted the matter back to the BoR for reassessment.

Our observation

This case establishes a significant precedent and opens up the possibility for the apportionment of royalty income between onshore and offshore activities. This view diverges from the IRD's previous stance, as stated in the 2013 Annual Meeting between the HKICPA and the IRD, that apportionment of royalty income would not normally be warranted. We welcome the CA's decision, which paves the way for the possibility of apportionment of royalty income.

On the other hand, this case reinforces the principles established in previous cases, such as Li & Fung[1] and ING Baring[2]. The CA reaffirmed that it is incorrect to disregard the agent's activities when determining the source of profits of the principal. It is not necessary for someone to be an agent in the full legal sense, but only for a person to be acting on the taxpayer's instructions and carrying out actions on his behalf. In addition, the basis of remuneration to the agent (whether a fixed fee or percentage of income) and the accounting treatment do not dictate the assessment of tax.

This case also provides thorough discussions from a practical and business perspective on the factors used to determine whether a receipt is of a capital or revenue nature. These factors include whether the payment is made once and for all or recurs regularly, whether the transaction is, in substance, a disposal of a capital asset, and whether the disposal of the asset is accompanied by a transfer of risk, among others.

Although this case opens up the possibility of apportionment for royalty income, one should bear in mind that offshore-sourced royalty income received in Hong Kong are subject to the foreign-sourced income exemption regime since its implementation in 2023. In particular, offshore royalties derived from trademarks, which are non-qualifying intellectual properties, would not be qualified for exemption. Companies engaged in similar sub-licensing arrangements should monitor development and seek professional advice in assessing the taxability of royalties.

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[1] *Commissioner of Inland Revenue v. Li & Fung (Trading) Ltd [2012] 3 HKLRD 8*

[2] *ING Baring Securities (Hong Kong) Ltd v. Commissioner of Inland Revenue [2018] 1 HKLRD412; (2007) 10 HKCFAR 417*

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