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The problem of cross-border taxation of royalties based on the Hong Kong judicial practice

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On the 17th of October in 2024 Hong Kong's Court of Appeal (CoA) made a remarkable decision in Patrick Cox Asia Limited case (2024 HKCA 944) [4] reviewing the decision of the Court of First Instance [5] and altering the decision of the Board of Review, an independent statutory body to hear and determine tax appeals (sec. 65 of the Inland Revenue Ordinance (IRO) [2]). The subject matter of the case pertains to the taxability of specific types of income received by a local corporate taxpayer.

Hong Kong is a jurisdiction with only four taxes (Property tax, Salaries tax, Profits tax [2] and Hotel Accommodation Tax [3]) and territorial source principle [6], under which profits tax shall be imposed only on «profits arising in or derived from Hong Kong» (sec. 14 of the IRO) [2]. The IRO does not provide for any list of taxable profits or any legal mechanism to identify them which leads to many tax disputes over the profits tax, and the aforementioned case is not an exception.

So, the Taxpayer in the aforementioned case is a Hong Kong company wholly owned by its UK parent company which was the owner of particular trademarks and then granted the Taxpayer the Master Licence vesting the latter with the right to issue sub-licences. The Taxpayer concluded a Deed of Cooperation with a Japanese company, authorizing it to represent the Taxpayer's group in Japan, as well as to procure sub-licence agreements acting as the Taxpayer's agent and to partake in sharing the royalties between the Taxpayer and the Japanese company in a ratio of 60:40. In its turn, the Japanese company made an upfront payment to the Taxpayer. During the 4-year period (2009-2013), the Japanese company concluded 3 sub-licence agreements with 3 Japanese sub-licensees representing the Taxpayer rather than being a party to them. One sub-licence agreement stipulated royalties as a percentage of sub-licensee's sales or net turnover, while the others contained the specified minimum amounts of royalties.

So there are two types of income received by the Taxpayer: the 40% Royalties and the Upfront Payment. The Taxpayer appealed against the decision of the Court of First Instance stating that all the income was offshore-sourced and the Upfront Payment was a capital receipt.

In order to ascertain the source of the 40% Royalties, the CoA focused on the direct profit-producing activities, all of which, apart from the acquisition of the Trademarks under the Master Licence, were carried out in Japan by the Japanese company and were attributed to the Taxpayer since it was sufficient that the activities were conducted on the Taxpayer's behalf and for its account under its instructions. Referring to Commissioner of Inland Revenue v. HK-TVB International Ltd [1992] 2 AC 397, the CoA stated that with respect to two sub-licence agreements the territoriality of intellectual property (IP) rights was not material for determining the source of profits since the royalties were fixed outright payments. Thus, not all parts of the direct profit-producing activities took place outside Hong Kong, and the 40% Royalties were not entirely offshore sourced which led to the possibility of their apportioning and imposing profits tax on the part sourced in Hong Kong.

Then the CoA concurred that the Upfront Payment was received by the Taxpayer from the acquisition of the Trademarks under the Master Licence and the use of such a licence to enter into the Deed of Cooperation. Since both of the documents were negotiated and concluded by the Taxpayer in Hong Kong, it was established that the source of the Upfront Payment was Hong Kong and the Upfront Payment was revenue rather than capital income.

Eventually the CoA rejected the Taxpayer's appeal on the upfront payment but partly allowed the appeal on royalties remitting the case back to the Board of Review to consider apportionment of royalties.

The CoA's decision on Patrick Cox Asia Limited case is noteworthy because:

- The general source rules for royalties derived from sub-licensing of IP assets were altered. In order to ascertain the location of royalty income, not only the place of acquiring and granting the licence, but also the location of the marketing of the IP for sublicensing, the negotiation and procurement of the sub-licence agreements, as well as their performance should be taken into account.
- The application of the attribution rule was reaffirmed and extended to other types of income, including royalties, under appropriate circumstances.
- The CoA allowed the apportionment of royalties, unless it is explicitly prohibited by the IRO.
- Contract negotiation on the territory of Hong Kong may bring about some tax issues in Hong Kong.

Anyway, the final decision on this issue depends on whether a further appeal will be lodged to the Hong Kong Court of Final Appeal for a final ruling.

Thus, the case illustrates that the short legislative wording leads to complicated disputes where the judges have to develop economic concepts and tests. Courts of all countries, including Russia [1], face the problem of taxation of royalties, so the analysis of foreign judicial practice will be beneficial since it can help to develop a uniform approach promoting convergence in the field of international taxation and adherence to the principle of certainty in tax relations.

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