Case No. D23/96

Profits tax – royalties – trade mark – used in Hong Kong – section 15(1)(b) – section 70A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Christopher Chan Cheuk and Yu Yui Chiu.

Dates of hearing: 18 and 19 September 1995.
Date of decision: 10 July 1996.

The taxpayer was a Hong Kong company dealing with electronic home entertainment products. It was a wholly owned subsidiary of its parent company in US. The taxpayer paid royalty to its parent company so that the taxpayer could use the trade mark of the latter in the products the taxpayer made which were sold to its US customers. The taxpayer paid tax on all its profits.

Subsequently, the taxpayer applied to correct the profits tax assessment on the basis that the royalties income was not derived from Hong Kong. The Commissioner refused the application and the taxpayer appealed.

Held:

The Board was satisfied that the taxpayer did use the trade mark, and did use it in Hong Kong and that all of the royalty payments made in respect of the use of the trade mark were royalty payments made in respect of the trade mark in Hong Kong for the purposes of section 15(1)(b) of the Inland Revenue Ordinance.

Appeal dismissed.

[Editor's note: the taxpayer has filed an appeal against this decision.**]**

Case referred to:

D6/91, IRBRD, vol 5, 556

Luk Nai Man for the Commissioner of Inland Revenue.
Michael Olesnicky of Baker & McKenzie for the taxpayer.

Decision:

This is an appeal by a Hong Kong private limited company against a refusal by an assessor to correct profits tax assessments for the years of assessment 1985/86 to 1989/90 and against profits tax assessments for the years of assessment 1990/91 and 1991/92 raised on it in respect of its American parent corporation. The appeal relates to royalty income which the assessor decided arose from the use of a trade mark in Hong Kong. The facts are as follows:

1. The American corporation was the owner in America, Hong Kong, and elsewhere of valuable trade marks which comprised the name of the American corporation. The trade marks were used in respect of electrical and electronic products sold primarily to customers in America but also worldwide.

2. The Hong Kong company was a private company incorporated in Hong Kong which at all relevant times was a wholly owned subsidiary of the American corporation.

3. There was a close relationship between the American corporation and its subsidiary, the Hong Kong company. The Hong Kong company caused goods to be made by third parties in Hong Kong, China, Malaysia, Thailand, Taiwan, Japan and South Korea bearing the name of its parent. These goods which were manufactured on the instructions of and for the Hong Kong company were purchased by the Hong Kong company from the manufacturers and sold by the Hong Kong company to department stores and others, primarily in USA but also elsewhere. The Hong Kong company did not sell any goods to customers in Hong Kong. The goods were then sold by the customers of the Hong Kong company to end users.

4. The Hong Kong company had an agreement with its parent, the American corporation, that the American corporation would provide a number of services to the Hong Kong company. These included design of products, after sales service, the promotion of the brand name, and either assisting in or finding customers for the goods sold by the Hong Kong company. For all of these services the Hong Kong company had an agreement with its parent under which it paid service charges, the cost of which are not subject matter of this appeal.

5. The Hong Kong company had an agreement with its parent, the American corporation, dated 1 April 1984 whereby the American corporation granted to the Hong Kong company the right to use the name of the American corporation in return for the payment of a royalty. The relevant parts of this royalty agreement read as follows:

‘(The American corporation) holds the right for the use of the trade mark, “XYZ” for electronic home entertainment products sold in the United States of America (US). (The Hong Kong company) wishes to continue to sell “XYZ” brand products to customers with locations in the US.’

‘(The Hong Kong company) agrees to pay (the American corporation) for the use of the “XYZ” trade mark on products it sells to its US customers. The fee to be paid will be 1 percent of the sales price of the products sold to the US customers of (the Hong Kong company). If during any fiscal year ending March 31, sales by (the Hong Kong company) to US customers exceed $50,000,000, the fee on the excess sales will be 1/2 percent of the sales price of products sold in excess of $50,000,000. Payment of the royalty fees will be due within thirty days after the end of each month.’

6. By virtue of an agreement dated 1 April 1987 the American corporation and the Hong Kong company entered into a new royalty agreement in similar terms to the royalty agreement dated 1 April 1984 except that the rates of royalty payable were revised upwards from 1 percent to 1.8 percent and 1/2 percent to 1 percent respectively.

7. By letter dated 11 July 1991 the American corporation wrote to the Hong Kong company and placed on record that it had been agreed that the rates of royalty payable should be further increased to 2% of all US sales for all fiscal periods beginning with 1 April 1987. The reason given for this increase was because ‘the value of the “XYZ” name in the US and the maintenance of that name in the US has seen a substantial cost increase since the last amendment. This is due primarily to the increased costs of national and co-op advertising during this period and the extension of the trade mark to other products which require additional state side efforts on our part.’ Although reference was made to this second upward revision taking effect from 1 April 1987 it appears that in fact the second upward adjustment of royalty may have taken place in the financial year ended 31 December 1991.

8. At all relevant times, the Hong Kong company carried on business in Hong Kong and paid profits tax on all of its profits on the basis that all of its profits were sourced in Hong Kong.

9. The Hong Kong company (as agent for the American Corporation) filed profits tax returns during the relevant period with respect to all royalties received by the American corporation from the Hong Kong company. The royalties were disclosed in returns filed with respect to the years of assessment 1985/86 to 1989/90. With respect to years of assessment 1990/91 and 1991/92, profits tax returns were filed that disclosed only royalties paid with respect to goods which had been manufactured in Hong Kong.

10. The following profits tax assessments were raised in respect of the royalty payments:

27 November 1986	A notice of assessment and demand for profits tax for the year of assessment 1985/86 was issued in the name of the Company (as agent for the American Corporation), showing assessable profits of $810,846 and tax payable thereon of $150,006. The tax was paid as assessed.
15 December 1987	A notice of assessment and demand for profits tax for the year of assessment 1986/87 was issued in the name of the Company (as agent for the American Corporation), showing assessable profits of $1,447,544 and tax payable thereon of $273,345. The tax was paid as assessed.
14 November 1988	A notice of assessment and demand for profits tax for the year of assessment 1987/88 was issued in the name of the Company (as agent for the American Corporation), showing assessable profits of $2,448,745 and tax payable thereon of $440,774. The tax was paid as assessed.
8 December 1989	A notice of assessment and demand for profits tax for the year of assessment 1988/89 was issued in the name of the Company (as agent for the American Corporation), showing assessable profits of $3,170,328 and tax payable thereon of $538,955. The tax was paid as assessed.
20 November 1990	A notice of assessment and demand for profits tax for the year of assessment 1989/90 was issued in the name of the Company (as agent for the American Corporation), showing assessable profits of $12,233,861 and tax payable thereon of $2,018,587. The tax was paid as assessed.

11. On 25 September 1991 the Hong Kong company applied through its tax representative (the First Tax Representative) to correct the profits tax assessments for the years of assessment 1985/86 to 1989/90 pursuant to section 70A of the Inland Revenue Ordinance (the IRO) on the basis that the royalties income was not derived from Hong Kong and should not be chargeable to Hong Kong profits tax because some of the products were manufactured offshore.

12. By letter dated 7 July 1992 the First Tax Representative informed the assessor that the royalty charges and the terms of the royalty agreements were decided by the American corporation and that no negotiation of the same ever took place in Hong Kong.

13. By letter dated 21 April 1993 the assessor refused the application by the Hong Kong company under section 70A of the IRO.

14. By letter dated 20 May 1993 the Hong Kong company acting through its First Tax Representative objected to the assessors' refusal to accept the application of the Hong Kong company made under section 70A of the IRO.

15. On 9 November 1993 the assessor issued an assessment to profits tax for the year of assessment 1991/92 in the name of the Hong Kong company (as agent for the American corporation) showing assessable profit of $7,574,174 and tax payable thereon of $1,249,738. On 12 November 1993 the assessor issued an assessment to profits tax for the year of assessment 1990/91 in the name of the Hong Kong company (as agent for the American corporation) showing assessable profits of $5,666,709 and tax payable thereon of $935,006.

16. On 30 November 1993 the Hong Kong company acting through its First Tax Representative objected to the profits tax assessment for 1991/92 and on 1 December 1993 the Hong Kong company acting through its First Tax Representative objected to the profits tax assessment for 1990/91.

17. On 14 February 1994 the Hong Kong company appointed the Second Tax Representative as its new tax representative.

18. On 16 February 1994 the Hong Kong company acting through its Second Tax Representative requested the Commissioner to reconsider the profits tax assessment for the years of assessment 1985/86 to 1991/92 on the basis that the royalty income which accrued to the American corporation fell outside the ambit of section 15(1)(b) of the IRO since the Hong Kong company did not sell the products carrying the 'XYZ' trade mark in Hong Kong and therefore did not use the trade mark in Hong Kong and that the Hong Kong company had previously misinterpreted the phrase 'use in Hong Kong' in section 15(1)(b) of the IRO by equating the same with 'used in connection with a business carried on in Hong Kong'.

19. On 13 February 1995 the Commissioner by his determination upheld the assessor's refusal to correct the profits tax assessment for the years of assessment 1985/86 to 1989/90 under section 70A of the IRO and confirmed the profits tax assessments for the years of assessment 1990/91 and 1991/92 against which the Hong Kong company had objected.

20. On 9 March 1995 the Second Tax Representative gave notice of appeal to the Board of Review against the determination of the Commissioner.

At the hearing of the appeal before the Board of Review the Taxpayer was represented by its solicitor and called two Executives of the Hong Kong company to give evidence.

The first witness said that she was familiar with the general operations of the Hong Kong company except for financial accounting matters. She explained how the Hong Kong company operated. The second witness was the General Manager of the Quality Control and Engineering Department of the Hong Kong company and he gave evidence with regard to how the Hong Kong company designed its products and had them made for it.

The evidence of both of the two witnesses is accepted by the Board. It is not necessary for us to set out the evidence given at length because the solicitor for the Hong Kong company provided the Board with his summary of the evidence which he had called and which we accepted as follows:

a. The Hong Kong company sold products only to customers who were outside Hong Kong. It had no Hong Kong customers.

b. Products were manufactured both outside Hong Kong and inside Hong Kong.

c. Those products that were manufactured outside Hong Kong never entered Hong Kong (except for some transhipment of goods produced in Malaysia and, latterly, in the PRC). Products were shipped directly from manufacturers to customers.

d. No selling activities were conducted in Hong Kong, that is, no negotiations with customers. No sales staff were employed by the Hong Kong company. Selling activities were conducted and coordinated by the American corporation in the USA. Customers dealt with the American corporation and forwarded their purchase orders to the American corporation.

e. The Hong Kong company paid certain fees to the American corporation for the services that were provided by the American corporation.

f. The goods were not advertised in Hong Kong.

g. The Hong Kong company’s activities in Hong Kong were limited to handling paperwork; receiving purchase orders from the American corporation; issuing purchase orders to manufacturers; arranging and handling letter of credit facilities; coordinating shipments of goods; and liaising with manufacturers concerning production of goods.

h. Liaison with manufacturers outside Hong Kong was conducted through liaison offices of the Hong Kong company (Thailand) or the American corporation (Japan, Taiwan, Korea).

i. The 'XYZ' trademark existed in many countries, including the countries where goods were manufactured (Taiwan, Japan, Malaysia, Thailand, Hong Kong) and in countries where goods were sold (USA).

j. The 'XYZ' trademark was physically applied to the products by the manufacturers.

k. Products were designed outside Hong Kong by the American corporation and unrelated designers. No designs were produced in Hong Kong. Manufacturing moulds were produced in the countries where the relevant goods were manufactured (with one exception).

The solicitor for the Hong Kong company referred to section 15(1)(b) of the IRO and quoted the relevant part as 'sums, not otherwise chargeable to tax under this part, received by or accrued to a person for the use of or right to use in Hong Kong a trademark'. He said that the Commissioner contended that the license fees were paid for the use in Hong Kong of the XYZ trademark. On the other hand the Hong Kong company argued that the XYZ trademark was not used in Hong Kong. Alternatively if the Board found that the trademark was used in Hong Kong then the Hong Kong company would argue that the payments were made not for Hong Kong use but for foreign use of the trademark.

The solicitor then referred to section 70A of the IRO and submitted that an error existed in that the Hong Kong company filed returns for the years of assessment 1985/86 to 1989/90 taking the incorrect view that the license fees were paid to the American corporation for use in Hong Kong of the XYZ trademark. He submitted that the Hong Kong company was in error in so doing. He said that if the Board found that in fact and in law the payments were made for the use outside of Hong Kong of the XYZ trademark then logically if followed that the Hong Kong company made an error when it prepared and filed the relevant returns. He said that this was not a case where the Hong Kong company had simply formed an opinion which it had changed. He said that the Hong Kong company paid the license fees to the American corporation either for the use of the XYZ trademark in Hong Kong or not for use in Hong Kong. He said that this was not a case where different people could legitimately take different views. He said that there could only be one correct answer and that if the Board were to find that the Hong Kong company had adopted the incorrect view then the Hong Kong company must succeed in its appeal. He referred the Board to D6/91, IRBRD, vol 5, 556.

The solicitor then went on to the substantive issue which was the use of the XYZ trademark. He said that there were two separate issues namely:

a. Did the company use the trademark in Hong Kong?

b. Were the license fees paid for use of the trademark in Hong Kong?

He submitted that the Hong Kong company did not use the trademark in Hong Kong because there were no sales to customers in Hong Kong and because all customers were outside Hong Kong. He said that it was not relevant that some products were manufactured in Hong Kong in the absence of sales in the Hong Kong market. He said that alternatively 'use in Hong Kong' was confined to affixing the trademark to goods that were manufactured in Hong Kong. To the extent that products were manufactured outside Hong Kong, the use of the trademark was outside Hong Kong. He said that if the alternative argument were adopted then it would be necessary to apportion the fees between products manufactured inside Hong Kong and outside Hong Kong.

He said that if the Board took the view that the Hong Kong company did use the trademark in Hong Kong, nevertheless the Hong Kong company payments were made only with respect to use of the trademark outside Hong Kong.

The solicitor then referred us to the meaning of 'use' in relation to trademark and cited a number of cases and textbooks to us which it is not necessary for us to set out in this decision. He submitted that on these authorities a trademark was 'used' when the goods to which it had been applied were sold. In the present case nothing had been sold to purchasers in Hong Kong. Accordingly it could not be said that the trademark had been used in Hong Kong. He submitted that for a trademark to be used it must be used in relation to goods sold within the particular country. He referred us to a number of trademark cases relating to use and non use. He said that mere transshipment of branded products through Hong Kong does not amount to use of a trademark in Hong Kong.

He then submitted that the use of a trademark on documents such as invoices was not use in Hong Kong if the goods were not sold in Hong Kong. He said that such use was use outside of Hong Kong. He said that if as a matter of trademark law the application of a trademark to goods for export constituted use of a trademark within Hong Kong then apportionment would be necessary.

The solicitor went on as an alternative submission to say that even if the Hong Kong company did use the trademark in Hong Kong the payments made by the Hong Kong company were for use outside of Hong Kong. He referred us to the terms of the royalty agreement which made it clear that although the American corporation licensed the Hong Kong company to use the trademark nevertheless the license fee was paid solely for the use of the trademark on products sold to USA customers. He said that this wording made it clear that no part of the license fee was attributable to the mere use of the trademark on stationery and paper in Hong Kong. The Hong Kong company was not paying for such use if it was used. In the royalty agreement it clearly stated on products and this made it clear that the payments were solely attributable to use of the trademark physically on the products. He said that this did not occur in Hong Kong but in USA.

The Commissioner was represented by a chief assessor. He submitted that there were two issues to be decided by the Board namely whether there was an error in terms of section 70A of the IRO and secondly whether the royalties in question were caught by section 15(1)(b).

With regard to section 70A he asked the Board to follow D6/91, IRBRD, vol 5, 556. The representative for the Commissioner cited to us the following passage with which we agreed:

> 'With regard to whether or not a change or difference in opinion can be an error or omission we make no general ruling or application to all cases. In our opinion each case must be heard and decided on its own merits. If the same facts are capable of two different interpretations both of which can be correct and are opinions only then there would be in our opinion be no error or omission. If on the other hand there is only one true and correct interpretation then it is not a matter of opinion.'

He said that in the present case two questions were involved namely the correct interpretation of section 15(1)(b) and secondly in respect of what were the royalties paid.

The representative said that there was a dearth of authority relating to the 'use of trademark in Hong Kong'.

He said that the solicitor representing the Hong Kong company had approached the question from the wrong angle. He said that one should not look at use from the view point of the purchaser but should view it from the trademark proprietor. Trademark law was there to protect the legitimate interest of the proprietor and stopped unfair trade practice. He said that if one applied section 15(1)(b) as proposed on behalf of the Hong Kong company it would mean that there would be a strange result. He pointed out that a Japanese manufacturer who was paid royalties on goods manufactured in China and which were then sold in Hong Kong would find the royalties taxable under section 15(1)(b) because the sales of the goods had taken place in Hong Kong. He submitted that that was not the intention of section 15(1)(b) of the IRO.

With regard to the many cases cited on behalf of the Hong Kong company relating to use of a trademark under trademark law the representative for the Commissioner submitted that these cases were not relevant to the IRO. He then referred to the cases which had been cited and sought to distinguish the same.

With regard to the submission made on behalf of the Hong Kong company that the royalty payments could only be applicable to goods manufactured in Hong Kong the representative for the Commissioner said that this was too restrictive. He said that the assessability to tax should not depend upon where the trademark was affixed to the goods.

In relation to the wording of the royalty agreement he pointed out that the agreement stated that the royalties were for the use of a trademark on the products to be sold to US customers and that that was precisely what happened. The Hong Kong company held itself out as the owner and vendor of goods bearing the trademark. Almost all of its sales were to US customers and those goods were sold by the Hong Kong company from Hong Kong to customers in the USA. The royalties formed part of the business expenses of the Hong Kong company for the earning of profits arising in or derived from Hong Kong. He said that if there was no royalty agreement and if the Hong Kong company were not related to the American corporation then the result would be legal proceeding brought against the Hong Kong company in Hong Kong.

This case is a very interesting case and raises a question which apparently has not been previously considered by Boards of Review or Courts in Hong Kong. That is the question arising under section 15(1)(b) of the IRO. However before turning to that question we will first deal with the question arising in respect of section 70A of the IRO.

As mentioned above we consider the Board was correct in D6/91. Section 70A is of limited application. However as submitted by the solicitor for the Hong Kong company whether or not the royalties are taxable under section 15(1)(b) is not a matter of different people forming different views. There can only be one correct answer and that is a question of law and fact. This is not a case where different professional advisors have taken different views or the Hong Kong company has sought to change the method whereby it carried on its business. The Hong Kong company has followed a practice or procedure which it thought was correct. Subsequently it has reconsidered the matter and has reached the conclusion that it was previously wrong and in error. If we were to find that the royalty payments were not within the ambit of section 15(1)(b) we would then consider this an appropriate case for the application of section 70A.

Having dealt with the section 70A question we now turn to the difficult and important question which is the heart of this appeal. This is the meaning of a provision in the IRO. The question is the construction and interpretation of words appearing in section 15(1)(b) of the IRO. For convenience we set out these words again as follows:

> *'sums, not otherwise chargeable to tax under this part, received by or accrued to a person for the use of or right to use in Hong Kong a trademark'.*

It is surprising that the meaning of these words has not come before Board of Review and Court frequently in the past. Hong Kong has long been a trading and manufacturing centre. It has been used to source many products bearing well known international trademarks and royalty payments must have frequently been paid to overseas trademark owners. Apparently there is a little authority on this question and we are therefore mindful of the importance of the decision which we now reach.

The meaning and intent of the words in section 15(1)(b) set out above is quite clear and there is no ambiguity. Anyone who receives money for the use of or right to use in Hong Kong a trademark will pay tax on the money which he receives. As we well know Hong Kong is a territorial tax jurisdiction and the words 'arising in or derived from' which appear so frequently in the IRO have been the subject matter of much vexed litigation. In the present section we have the words ‘use in Hong Kong’ which has a territorial connotation but is not necessarily the same as ‘arising in or derived from Hong Kong’.

We have not set out above at length the submissions and authorities cited on behalf of the Hong Kong company and its American parent relating to the use of a trademark for trademark law purposes. Likewise we have not set out at length the rebuttals or other submissions made by the representative for the Commissioner with regard thereto. This is because we find the cases and authorities of little help to us in deciding the question now before us. The cases relating to use of trademarks are all of a technical nature under trademark law. For example there are very extensive authorities on what constitutes use of a trademark for infringement purposes or for acquiring or losing exclusive rights to a registered trademark. By way of example we mention that there is a complete part of the Hong Kong Trade Marks Ordinance entitled ‘Use and non use of Trade Marks’. If we were to follow the submission made on behalf of the Hong Kong company we would have to consider whether or not this part of the Trade Marks Ordinance should be imported into the IRO. We consider that would not be appropriate. The intention of the IRO is to tax money paid by one person to another for the ‘use’ in Hong Kong of a trademark. In this context the word ‘use’ is to be given its ordinary meaning and not a technical meaning attributed to it for trademark law purposes. However this does not mean that one should ignore trademark law and seek to give the word ‘use’ a different meaning. What one must do is to give it a normal meaning.

In our opinion there can be no doubt whatsoever that the Hong Kong company did use the trademark. Indeed this is common ground by both parties. The only question in dispute between the parties is where the use took place and whether or not the royalty payments were all attributable to use in Hong Kong. We find that the Hong Kong company did use the trademark, did use the trademark in Hong Kong, and that all of the royalty payments made in respect of the use of the trademark were royalty payments made in respect of the use of the mark in Hong Kong for the purposes of section 15(1)(b) the IRO.

In reaching this decision we have taken as our starting point the royalty agreement itself. This is the document from which the payments arose. Although the royalty payment changed on two occasions the relevant part of the royalty agreement remained the same. It was an agreement between a parent in America and its subsidiary in Hong Kong. The first paragraph which we have quoted in the facts set out above is no more than a recital. It said that the parent held the right for the use of the trademark for products sold in the United States of America and that the subsidiary wished to continue to sell such products to customers in the United States of America. The important paragraph is the second paragraph which states that the Hong Kong company agreed to pay its parent ‘for the use of the XYZ trademark on products it sells to its US customers’. That was the right granted by the parent to its subsidiary and it was for that right that the royalty was paid.

We accept that for trademark law purposes the trademark on the facts before us could have been and no doubt was used in many places and possibly by many different persons. What happens in the real world frequently does not fall into neat and tidy areas. Law students learn about the law of contract based on offers, acceptances and consideration.

However when this simple legal principle is applied in the real world it is often difficult to see who has offered what, to whom, for what, and where. We have a similar sort of problem now to be resolved. Use is a simple word having a simple but very wide meaning. Applying it to the facts now before us we have no doubt that the trademark was used in Hong Kong, was used in all of the countries where the goods were made, and was used in all of the countries where the goods were ultimately sold and which we were told was primarily USA. For trademark law purposes the application of the trademark to the goods themselves and to packing materials and other paper articles by the manufacturers of the goods would no doubt constitute use. Whose use it was is more difficult to answer. Probably depending upon the relevant trademark law it could be successfully argued that the mark had been used in the country of manufacture by the owner of the mark and/or its Hong Kong subsidiary, and/or the manufacturers in the various countries. Possibly it had been used by even more persons, for example, the persons who made labels for the goods or printed packing materials, or applied the mark to printed articles. If the mark was embossed on moulds this would also constitute a possible use by the mould maker.

Whilst this may be very interesting we find it of little help to us in deciding the case before us. As we have said earlier the royalty was paid by the Hong Kong company to the American corporation for the use by the Hong Kong company of the trade mark in relation to goods which the Hong Kong company sold to its US customers. The Hong Kong company carried on its business in Hong Kong. It paid tax on all of the profits which it made and these were made in Hong Kong. This is common ground between the parties. Without the licence from its parent the Hong Kong company could not have carried on its business in Hong Kong. We were asked by the solicitor for the Hong Kong company to consider apportionment of the royalty if we considered that there was a use of the mark in Hong Kong. We find it inappropriate to consider any such apportionment. The royalty payment was one indivisible sum paid by the Hong Kong company for using the mark. No doubt the parties to the licence agreement could have worded that agreement differently, but what we have to consider is the agreement as it appears before us. The Hong Kong company paid one indivisible royalty to its parent for the use of the mark. It carried on its business in Hong Kong and that is where it used the trade mark for the purposes of the IRO.

We note that originally the Hong Kong company and its parent in USA were of the same opinion and paid tax for a number of years on the basis that the trade mark had been used in Hong Kong and that the royalty payment was for this use. We consider this to have been a correct view of the law and the facts.

For the reasons given we dismiss this appeal and confirm the determination of the Commissioner against which the Hong Kong company has appealed.