Case No. D39/89

Profits tax – source of royalty – publisher of books – royalty income – whether arising in or derived from Hong Kong – Sinolink case applied.

Panel: T J Gregory (chairman), Herbert Liang Hing Yin and Woo Manuel Rosas.

Date of hearing: 15 June 1989.
Date of decision: 22 August 1989.

The taxpayer carried on business in Hong Kong publishing books. It entered into a series of agreements as a result of which it received income from a Japanese publisher which the taxpayer claimed did not arise in and was not derived from Hong Kong.

Held:

Applying the decision in Sinolink Overseas Limited v CIR, the taxpayer's receipts from the publishing agreements arose in and were derived from Hong Kong.

Appeal dismissed.

Cases referred to:

CIR v The Hong Kong & Whampoa Dock Co Ltd [1960] 1 HKTC 85
Sinolink Overseas Ltd v CIR [1985] 2 HKTC 127
Bank of India v CIR Inland Revenue Appeal No 4 of [1988]
International Combustion Ltd v The Commissioner of Inland Revenue 16 TC 532
Vacu-lug (Pvt) Ltd v Commissioner of Taxes 25 SATC 201
Millin v Commissioner of Inland Revenue 3 SATC 170
Commissioner of Taxation v British United Shoe Machinery (SA) (Pty) Ltd 26 SATC 163
Shiner v Lindblom [1960] 3 All ER 803
11 CTBR (NS) Case 39
Collins v The Firth-Brearley Stainless Steel Sydnicate Ltd [1925] 9 TC 520
British Salmson Aero Engines Ltd v I R Commissioners [1938] 22 TC 29
FL Smidth v Greenword [1921] 3 KB 581
Rhodesia Metals Ltd v Taxes Commissioner [1940] 3 All ER 422
Nethersole v Withers [1946] 1 All ER 711

Wong Chi Wah for the Commissioner of Inland Revenue.

Mak Hing Cheung of Mak Hing Cheung & Co for the taxpayer.

Decision:

1. THE NATURE OF THE APPEAL

1.1 The Taxpayer appealed against the determination of the Commissioner ('the determination'), issued on 13 July 1988, which rejected the Taxpayer's objection to profits tax assessments for the years of assessment 1983/84 and 1984/85 and the additional profits tax assessment for the year of assessment 1984/85 raised on it.

1.2 The Taxpayer objected to the inclusion in those assessments of what were referred to as Overseas Patent Right Receipts ('OPRR') which the Taxpayer claimed had a source outside Hong Kong and, accordingly, were not chargeable to profits tax.

2. THE FACTS

The background facts, which are not in dispute, may be summarised as follows:

2.1 At the relevant times the Taxpayer carried on business in Hong Kong publishing books.

2.2 An agreement in writing dated 16 August 1983 and made between the Taxpayer and the copyright owners, (the 'principal agreement'), recorded the terms to regulate the publication of what is described as a 'pictorial story book' adapted from a famous Chinese classical literary work. The copyright owners were the author and his publishers of this illustrated literary work (the 'copyright owners') and all of the evidence points to the fact that, at all material times, both were residents of the People's Republic of China ('PRC').

2.3 The principal agreement was the fourth agreement between the Taxpayer and the copyright owners but, on the basis of the facts stated in paragraph 1(12) of the determination, there were no formal agreements with respect to the first three of these agreements ('the informal agreements').

2.4 Each of the informal agreements and the principal agreement related to an individual illustrated literary work, none of which appear to have been given an English title, and, for the purpose of the agreements referred to in paragraph 2.9 below, they have been referred to as 'pictorial A', 'pictorial B', 'pictorial C' and 'pictorial D'. The informal agreements related, respectively, to 'pictorial

A', 'pictorial B' and 'pictorial C'. The principal agreement related to 'pictorial D'.

2.5 The principal agreement came about as a result of a letter from the Taxpayer to the copyright owners, refer the letter dated 13 April 1983 at appendices F-2 and F-3 to the determination and refer paragraphs 2.7 and 3.1.1.17 below.

2.6 The relevant terms of the principal agreement are as follows:

2.6.1 Clause 1: the copyright owners and the Taxpayer were to co-operate in the publication of a 'Hong Kong Chinese edition' and 'foreign language edition' of the four volumes comprising 'pictorial D'.

2.6.2 Clause 3: the copyright owners would provide pictures to enable the printing plates to be made whereafter the pictures were to be returned.

2.6.3 Clause 4:

2.6.3.1 the Taxpayer was to be responsible for the design of the binding and the layout of the 'Hong Hong Chinese edition' which was to be published and put on sale in Hong Kong;

2.6.3.2 the Taxpayer was to have the copyright for the 'Hong Kong Chinese edition'; and

2.6.3.3 the Taxpayer would pay the copyright owners a royalty on the basis recorded.

2.6.4 Clause 5:

2.6.4.1 the Taxpayer was to be responsible for making contact with foreign institutions to negotiate the 'foreign language edition' of 'pictorial D' and provided for a minimum royalty which was to be shared equally between the copyright owners and the Taxpayer; and

2.6.4.2 the copyright in any foreign language editions was to be reserved to the copyright owners.

2.6.5 Clause 7: the principal agreement was to be valid for a period of ten years from the date of signing, subject to negotiation for an extension.

2.7 The creation of the principal agreement is well documented:

2.7.1 a first draft was prepared in the PRC and sent to Hong Kong for signature, refer the letter dated 13 April 1983 at appendices F-2 and F-3 to the determination and refer paragraphs 3.1.1.16 and 3.1.1.17 below; and

2.7.2 after correspondence a final version was prepared by the copyright owners in the PRC and, after it had been executed by them in the PRC, it was sent to Hong Kong, in duplicate, for execution by the Taxpayer (an executed copy to be returned to the copyright owners) under cover of a letter dated 30 July 1983, a copy of which is in appendices F-2 and F-3 to the determination.

2.8 Factually, even after signature there was correspondence between the parties with respect to a variation, no doubt with reliance being placed on clause 7 of the principal agreement, which contains the following sentences:

> 'Should there be any details not specified in this agreement, both parties shall carry out consultations in settlement of the matter according to the principle of equality and mutual benefits.'

2.9 The Taxpayer entered into four agreements with a Japanese publisher (collectively the 'publishing agreements' and individually a 'publishing agreement') with respect to the illustrated works referred to in paragraph 2.4 above. These four publishing agreements were dated, respectively, 11 May 1982, refer document 3.1.1.2 below, which was with respect to 'pictorial A', 20 December 1982, refer document 3.1.1.3 below, which was respect to 'pictorial B', 28 June 1983, refer document 3.1.1.4 below, which was with respect to 'pictorial C', and 11 January 1984, refer document 3.1.1.5 below, which was with respect to 'pictorial D'. Each publishing agreement was expressed to be governed by and to be interpreted in accordance with the laws of Hong Kong.

2.10 The publishing agreements:

2.10.1 These are identical save as to:

2.10.1.1 the subject matter: the illustrated literary work is identified in the recital;

2.10.1.2 clause 3, the quantum of the payment on account of the agreed royalty: the amounts and method of calculation differ;

2.10.1.3 clause 4, the royalty rates: the first provides for graduated rates; and

2.10.1.4 clause 6, the sum to be paid for the 'duplicate negative film': the amounts differ.

2.10.2 Each describes the Taxpayer as 'the proprietors' and, after reciting that 'the proprietors have the right to make arrangement for the issue of the work (Chinese name given) … (hereinafter called "the work").' they provide:

2.10.2.1 by clause 1: for the publisher to be granted 'the exclusive licence to translate, publish and sell … the said work in book form … in the Japanese language … throughout the world.'

2.10.2.2 by clause 3: for a prepayment by the publisher on account of the agreed royalty;

2.10.2.3 by clause 4: for the payment by the publisher of a royalty;

2.10.2.4 by clause 5: for the royalty, including the payment pursuant to clause 3, to be made less the Japanese withholding tax of 20%;

2.10.2.5 by clause 6: for the publisher to purchase 'the duplicate negative film of the work';

2.10.2.6 by clause 16 a: a warranty that 'the proprietors are the sole owners of all the rights granted to the publishers'.

2.11 The creation of the publishing agreements is not in the least well documented. The only correspondence available to the Board, and, presumably, the Revenue, with respect to the publishing agreements are:

2.11.1 an undated letter to the Taxpayer, showing an address in Tokyo, refer document 3.1.1.18 below;

2.11.2 a letter dated 30 December 1981 addressed by the Taxpayer to the writer and at the address given in the undated letter referred to in paragraph 2.11.1 above, which has every appearance of being a reply to that undated letter and, hence, date it 17 December 1981, refer document 3.1.1.19 below; and

2.11.3 a letter dated 22 September 1982, addressed by the Taxpayer to a Hong Kong incorporated company at an address in the New Territories in which reference is made to a prior telephone conversation, refer document 3.1.1.20 below.

2.12 In the years of assessment to which this appeal relates the Taxpayer received payments from the Japanese publisher pursuant to the publishing agreements, which payments are referred to in the Taxpayer's audited accounts, the determination, prior and subsequent correspondence and in the grounds of appeal as OPRR. These payments are set out in paragraph 1(3) of the determination as follows:

'Name of books	Year ended 31 December			
	1981 $	1982 $	1983 $	1984 $

"Pictorial A"		52,000	7,143	
"Pictorial B"			89,154	
"Pictorial C"	20,000		101,005	
"Pictorial D"				23,237
	20,000	52,000	197,302	23,237'

3. DOCUMENTATION

3.1 The Board had before it copies of the following documents:

3.1.1 Copy documents available before the hearing of the appeal:

3.1.1.1 The determination;

3.1.1.2 The publishing agreement dated 11 May 1982, appendix A to the determination;

3.1.1.3 The publishing agreement dated 20 December 1982, annexed to which was a letter dated 15 April 1986 correcting an error, appendix A-1 to the determination;

3.1.1.4 The publishing agreement dated 28 June 1983, appendix A-2 to the determination;

3.1.1.5 The publishing agreement dated 11 January 1984, appendix A-3 to the determination;

3.1.1.6 The Taxpayer's auditors report for the year ended 31 December 1981, dated 19 August 1982, annexed to the accounts referred to therein, appendix B to the determination;

3.1.1.7 The Taxpayer's tax computation for its year ended 31 December 1981, appendix B-1 to the determination;

3.1.1.8 The Taxpayer's auditors report for the year ended 31 December 1982, dated 30 July 1983, annexed to the accounts referred to therein, appendix C to the determination;

3.1.1.9 The Taxpayer's tax computation for its year ended 31 December 1982, appendix C-1 to the determination;

3.1.1.10 The Taxpayer's auditors report for the year ended 31 December 1983, dated 30 July 1984, annexed to the accounts referred to therein, appendix D to the determination;

3.1.1.11 The Taxpayer's tax computation for its year ended 31 December 1983, appendix D-1 to the determination;

3.1.1.12 The Taxpayer's auditors report for the year ended 31 December 1984, dated 26 July 1985, annexed to the accounts referred to therein, appendix E to the determination;

3.1.1.13 The Taxpayer's tax computation for its year ended 31 December 1984, appendix E-1 to the determination;

3.1.1.14 Chinese language version of the principal agreement, appendix F to the determination;

3.1.1.15 English translation of the principal agreement, appendix F-l to the determination;

3.1.1.16 Eleven letters in Chinese exchanged between the copyright owners and the Taxpayer, appendix F-2 to the determination;

3.1.1.17 English translations of the eleven letters included in appendix F-2 namely five letters from the copyright owners (dated 13 April 1983, 8 June 1983, 30 July 1983, 7 September 1983 and 12 December 1983) and six letters from the Taxpayer (dated 28 April 1983, 22 July 1983, 16 August 1983, 24 September 1983, 16 November 1983 and 21 December 1983), appendix F-3 to the determination;

3.1.1.18 A letter from a company in Japan to the Taxpayer, undated;

3.1.1.19 A letter from the Taxpayer to the Japanese company dated 30 December 1981;

3.1.1.20 A letter from the Taxpayer to A Limited, dated 22 September 1982, appendix G to the determination, and refer paragraph 2.8 above; and

3.1.1.21 The Taxpayer's grounds of appeal with copies of the pages from the textbooks, law reports and other documents referred to therein.

3.1.2 Copy documents received during the course of the appeal:

3.1.2.1 A folder prepared by the Revenue containing copies of documents 3.1.1.2 to 3.1.1.5, both inclusive, 3.1.1.6 to 3.1.1.13, both inclusive, 3.1.1.14 and 3.1.1.15, 3.1.1.16 and 3.1.1.17 and 3.1.1.18 to 3.1.1.20, both inclusive; and

3.1.2.2 A folder prepared by the Revenue containing copies of the law reports and extracts from a textbook as follows:

3.1.2.3 CIR v The Hong Kong & Whampoa Dock Co Ltd [1960] 1 HKTC 85;

3.1.2.4 Sinolink Overseas Ltd v CIR [1985] 2 HKTC 127;

3.1.2.5 Bank of India v CIR IRA No 4 of 1988;

3.1.2.6 International Combustion Ltd v The Commissioner of Inland Revenue 16 TC 532;

3.1.2.7 Vacu-Lug (Pvt) Ltd v Commissioner of Taxes 25 SATC 201.

3.1.2.8 Silke on South African Income Tax, tenth edition (paragraphs 5.12 – 5.13);

3.1.2.9 Silke on South African Income Tax, tenth edition (paragraph 3.22).

4. THE CASE FOR THE TAXPAYER

4.1 No evidence was adduced from the Taxpayer.

4.2 The Taxpayer's representative went through each of the thirteen paragraphs comprising the grounds of appeal and read to the Board the extracts from the authorities referred to therein or in a note to each paragraph.

4.3 This submission may be summarised as follows:

4.3.1 Paragraphs 1 and 2:

Originally the assessors accepted the OPRR as non-Hong Kong sourced income. Subsequently, the assessors, relying on the decision in Millin v Commissioner of Inland Revenue 3 SATC 170, stated that the OPRR were Hong Kong income. It was submitted that the Millin case supported the Taxpayer: the representative referred the Board to a question, No 4(b)(ii), in the Hong Kong Society of Accountants December 1982 examination on 'Hong Kong Taxation and Tax Management', and the printed answer.

4.3.2 Paragraph 3:

The assessors made an incorrect application of the Millin case when they determined the OPRR to be Hong Kong sourced income. Such mistake was upheld by the Commissioner.

4.3.3 Paragraph 4:

The Millin case only applies to the original author and not a person who is not the original author. The Taxpayer was not the original author. The representative then read two passages from the judgment quoted in Silke on South African Income Tax, fifth edition, ('Silke 5') which are in paragraph 72 on pages 124 and 125.

4.3.4 Paragraphs 5 and 6:

The source of income received by way of copyright royalty by the original author is the place where he wrote the book. The original author of the work wrote in China and the author of the Japanese language edition wrote in Japan. Therefore, the source of the Japanese language royalty is not in Hong Kong. The representative then referred the Board to the first passage in paragraph 72 of Silke 5.

4.3.5 Paragraph 7:

The Taxpayer acquired the copyright from the copyright owners in China and received royalties by allowing the Japanese publishers to publish and sell the Japanese language version. Such royalty receipts are not assessable. The representative referred the Board to a third passage in paragraph 72 of Silke 5.

4.3.6 Paragraph 8:

The use by the Japanese publisher of the negatives supplied by the Taxpayer for the Japanese edition is the same as a person using its assets to create overseas income which is not assessable. The representative then referred to a passage from Commissioner of Taxation v British United Shoe Machinery Ltd 26 SATC 163 (quoted in paragraph 74 of Silke 5), a passage from Shiner v Lindblom [1960] 3 All ER 803 (quoted at paragraph 26/243 of Silke 5) and a passage from 11 CTBR (NS) Case 39 (quoted at paragraph 26/228 of Silke 5).

4.3.7 Paragraph 9:

The fact that the publishing agreements are governed by and are to be interpreted in accordance with the laws of Hong Kong is to provide protection to the Taxpayer and this is not relevant to the source of the royalty. The representative referred to a passage in paragraph 73 of Silke 5 commenting on the Millin case.

4.3.8 Paragraphs 10 and 11:

The Taxpayer originally acquired the pictures, that is the negatives, from the copyright owners in China for the purpose of investment or using what it had acquired as one of the capital assets or one of its income producing assets. The

granting of the licence to a third party to publish in Japanese was incidental and capital in nature. The representative then referred to two passages in paragraph 44 of Silke 5, a passage at paragraph 26/241 of Silke 5 and part of the headnote to and passages in the judgment in Collins v The Firth-Brearley Stainless Steel Syndicate Ltd [1925] 9 TC 520 at page 521 and from page 572. The representative submitted that British Salmson Aero Engines Ltd v I R Commissioners [1938] 22 TC 29 is authority for the proposition that' … sums received for an exclusive licence to use a patent for a specified period are to be held to be capital receipts', refer Silke 5 at paragraph 26/231.

4.3.9 Paragraphs 12 and 13:

The representative referred the Board to the International Combustion case, refer paragraph 3.1.2.6 above, and submitted that this case supported the proposition that the royalty payments from Japan were Japanese sourced. The representative requested that this case be read with the following substitutions:

4.3.9.1 The French firm by the Taxpayer;

4.3.9.2 The American owner by the copyright owners;

4.3.9.3 The Taxpayer (British) company by the Japanese publisher.

5. THE CASE FOR THE REVENUE

The Revenue's representative handed in a written submission the material parts of which are as follows:

5.1.1 The definition of the expression 'profits arising in or derived from Hong Kong' in section 2 of the Inland Revenue Ordinance, Cap 112 ('the Ordinance') is not exhaustive.

5.1.2 It is necessary to ascertain whether profits have an origin or source in Hong Kong.

5.1.3 Invariably, in considering the source of various kinds of profits the following tests are adopted in Hong Kong:

5.1.3.1 'where do the operations take place from which the profits in substance arise' – per Atkin LJ in FL Smidth v Greenwood [1921] 3 KB 581 at page 593.

5.1.3.2 'Source means not a legal concept, but something which a practical man would regard as a real source of income ... The ascertaining of the actual source as a practical hard matter of fact.' – per Atkin LJ in Rhodesia Metals Ltd v Taxes Commissioner [1940] 3 All ER 422 at page 426.

5.1.3.3 In CIR v The Hong Kong Whampoa Dock Co [1960] 1 HKTC 85 Reece J stated what, on the facts of that case, a practical man would regard as the real source of the profits.

5.1.3.4 In Sinolink Overseas Ltd v CIR [1985] 2 HKTC 127 Hunter J quoted Atkin LJ in the Smidth case and the Rhodesia Metals case and concluded that those tests, which raised a pure question of fact, were those to be applied.

5.1.3.5 In Bank of India v CIR IRA No 4 of 1988 the aforementioned conclusion of Hunter J was quoted with approval.

5.1.3.6 The Revenue's representative stated that royalties had not previously been the subject of any judicial decision. However, the Revenue's view was that the operations test should be applied to royalty income. In the application of the tests it is necessary to identify and locate the Taxpayer's operations which collectively produced the profits in question and, thereafter, whether, as a hard matter of fact, the proper conclusion is that the Taxpayer received the OPRR from a source in Hong Kong.

5.2 The Revenue's representative then reviewed the facts, namely:

5.2.1 The Taxpayer was a Hong Kong company carrying on a book publishing business with its permanent and only establishment being in Hong Kong.

5.2.2 Although the Taxpayer contended that its agreements with the copyright owners were negotiated and concluded in the PRC, no evidence had been provided to the Revenue to substantiate this and no evidence had been called at the appeal to support this contention. Conversely, the correspondence, refer the correspondence at appendix F-2 to the determination, established that the terms of the principal agreement were negotiated in correspondence and that the document was sent signed from the PRC to be accepted by the Taxpayer in Hong Kong, refer the copyright owners' letter dated 30 July 1983, whereby the principal agreement was made in Hong Kong.

5.2.3 Similarly it was alleged that the terms and details of the publishing agreements were negotiated and concluded in Japan but no evidence as to this had been provided to the Revenue nor was any evidence adduced at the appeal. Whilst there was expenditure of money on a visit to Japan by two ladies which was included in the income expenditure account of the Taxpayer for its year ended 31 December 1981, there was no supporting documentation with respect to this visit and the correspondence available indicates that the Taxpayer was in telephone communication and correspondence with a Japanese publisher through a Hong Kong company in Hong Kong, see the Taxpayer's letter of 22 September 1982.

5.2.4 The Taxpayer admitted that the publishing agreements were signed in Hong Kong and that they were to be governed by and interpreted in accordance with the laws of Hong Kong. The only evidence at the appeal was documentary and the documents supported the Revenue's view that the publishing agreements were negotiated and made in Hong Kong.

5.2.5 The Revenue submitted that the operations of the Taxpayer which gave rise to the OPRR took place in Hong Kong whereby as a practical hard matter of fact the only course available to the Board was to find that the source of the OPRR was Hong Kong whereby the profits in question are chargeable to Hong Kong profits tax.

5.2.6 The Revenue then referred to the tenth edition of Silke ('Silke 10') at paragraph 5.13 which reads:

'Other considerations apply where the royalties are derived by a person who is not the original author or inventor, for example, by a person who has acquired a copyright from the original author or patent rights from the original inventor, since the royalties are now derived not from the wits, labour or intellect of the recipient but from the ownership of the copyright or patent rights. The source or originating cause of the royalties may be the business of the owner of the rights, the employment of the capital invested in the acquisition of the rights, the contract providing for the earning of the royalties from the exploitation of the rights or, in appropriate circumstances and on the analogy of the British United Shoe Machinery case, the use of the rights. Each case will have to be considered on its own merits, since there appears to be no conclusive guide.'

5.2.7 The Revenue's representative submitted that the principles of the British United Shoe Machinery case were not applicable to the Taxpayer as the rights owned by the Taxpayer were in the nature of an intangible asset and that the acquisition and tenure of copyrights and turning them to account is part and parcel of the Taxpayer's business in Hong Kong. The representative submitted that this view was supported in a further passage from Silke 10 at paragraph 5.12 which reads:

'With the letting of smaller things for a more limited period, for example, motor cars, the business of the lessor, rather than the property let, was the source. The location of the source would then probably be the location of the business, and the occasional use of property in another country would probably be ignored. But in this case, regard being had to the nature of the property and the fact that the leases were of such long duration that the emphasis was on the property let and not on the business of the lessor, the source of the rent derived from the use of the property was located where the property was used, that is, in Rhodesia.'

'It must follow from this decision that it is too wide a proposition to state that the source of rent is always the asset the use of which gives rise to the rent, and the place where the asset is used by the lessee necessarily determines the situation of the source of the rent. Regard must be had to the nature of the property let, the nature of the lessor's business and the duration of the lease.'

5.2.8 The representative then requested the Board to note that the Taxpayer's business was in Hong Kong, that the agreements with the copyright owners were made in Hong Kong and that the publishing agreements were made in Hong Kong. Accordingly, the Board would have no difficulty in concluding that the source of the OPRR was Hong Kong.

5.3 The Revenue's representative then commented on the grounds of appeal as follows:

5.3.1 Paragraphs 1 to 6 were not relevant to the appeal as the Taxpayer was not the original author.

5.3.2 Paragraphs 7 and 8 required no comment further to that summarised at paragraphs 5.2.4, 5.2.6 and 5.2.7 above.

5.3.3 Paragraph 9: the representative acknowledged the fact that the publishing agreements were to be governed by and interpreted in accordance with the laws of Hong Kong was not conclusive. However, it was a factor to be taken into account when the question of source was under consideration.

5.3.4 Paragraphs 10 and 11 required no comment further to that summarised at paragraphs 5.2.6 and 5.2.7 above.

5.3.5 Paragraphs 12 and 13:

5.3.5.1 References to the International Combustion case were irrelevant as that case dealt with the tax liability of the licensee which, on an analogy with the present facts, meant the liability of the Japenese licensee to pay the Japanese tax.

5.3.5.2 Whether or not the OPRR should be held to be capital receipts or trading receipts could be decided on the basis of a further paragraph in Silke, tenth edition, paragraph 3.22 which reads:

'A distinction must be drawn between the cession or outright alienation of patent rights originally acquired for use in a business and a sub-letting of patent rights. Any consideration received for the cession of a right would be of a capital nature. Any consideration received for the sub-letting of a right would constitute a gain by an operation of business in the carrying out of a scheme of profit making and would therefore be in the nature of income.'

5.3.5.3 The representative then referred the Vacu-Lug case and to paragraphs 8, 9, 13, 14 and 17 of each publishing agreement (which are identical) which make it entirely clear that the Japanese publisher was not acquiring any rights to the copyright of the copyright owners but merely a licence to use that right.

5.3.5.4 The representative submitted that on the facts which had been established the Taxpayer had not acquired ownership of the copyright but merely the right to publish in Hong Kong and to negotiate with others for foreign language editions with any royalties received to be shared equally between the Taxpayer and the copyright owners. He then referred to a further passage from Silke 10 and the case of Nethersole v Withers [1946] 1 All ER 711 to the effect that a lump sum payment received for the grant of a patent licence for a term of a year may be a capital and not a revenue receipt but which it is depended on the particular facts of each case. The facts in this appeal were that the down payments received pursuant to the publishing agreements were on account of royalty payments. This established as a fact that there was not a 'sale' and that the rights were granted on a genuine royalty based on sales with the down payments being on account of those royalties.

6. REPLY ON BEHALF OF THE TAXPAYER

The Taxpayer's representative made a brief reply. Suffice it to say that he acknowledged that the Taxpayer had not acquired ownership of the several copyrights.

7. REASONS FOR THE DECISION

7.1 The matter in issue

This appeal is not concerned with the publication by the Taxpayer of the 'Hong Kong Chinese edition' of any of the illustrated literary works in question. It is concerned with the Taxpayer's receipts from the Japanese publisher paid pursuant to the publishing agreements.

7.2 The onus on the Taxpayer

7.2.1 It was for the Taxpayer to satisfy the Board that the determination was wrong because:

7.2.1.1 factually, the monies received pursuant to the publishing agreements did not arise in and were not derived from Hong Kong (refer paragraphs 1 to 9, both inclusive, of the grounds of appeal); and/or

7.2.1.2 factually, when it entered into each of the publishing agreements it was turning to account an asset which it owned whereby the receipts are to be treated as

capital receipts (refer paragraphs 10 to 13, both inclusive, of the grounds of appeal).

7.3 What was acquired by the Taxpayer?

7.3.1 One part of the Taxpayer's case was that the Taxpayer was dealing in one of its capital assets.

7.3.1.1 The informal agreements

The Taxpayer did not adduce any evidence to establish that:

7.3.1.1.1 it had acquired ownership of the copyright in 'pictorial A', 'pictorial B' and 'pictorial C' or ownership of the copyright in the 'duplicate negative film' pursuant to the informal agreements; or

7.3.1.1.2 any or all of the informal agreements was or were different to or was or were distinguishable from the principal agreement.

Accordingly, the Taxpayer has failed to satisfy the Board that its receipts from the publishing agreements with respect to each 'pictorial A', 'pictorial B' and 'pictorial C' were of a capital nature.

7.3.1.2 The principal agreement

The Board is able to identify precisely what the Taxpayer acquired when it entered into the principal agreement:

7.3.1.2.1 by clause 4: the right to publish and sell in Hong Kong a 'Hong Kong Chinese edition' of 'pictorial D' together with ownership of the copyright in that edition, subject to payment of a royalty; and

7.3.1.2.2 by clause 5: the appointment as an agent of the copyright owners to negotiate with overseas institutions for the publication of foreign language editions of 'pictorial D', the copyright in which was to remain with the copyright owners, such appointment to be remunerated by sharing the royalty income to be negotiated (the minimum being specified in the clause).

The Board finds that the Taxpayer did not acquire absolute ownership or title to the copyright owners' copyright in 'pictorial D' pursuant to the principal agreement.

7.3.1.2.3 As the Board is satisfied that clause 5 of the principal agreement did no more than constitute the Taxpayer the agent of the copyright owners for the purposes and on the terms stated in paragraph 7.3.1.2.2 above, it follows that the

description of any income from the publishing agreement with respect to 'pictorial D' as OPRR was incorrect. Nevertheless, that does not alter the liability, or otherwise, of this income to tax.

7.3.2 The Board notes that the Taxpayer did not include any 'patent rights' as fixed or current assets in its audited accounts.

7.3.3 The Board agrees with the Revenue's submission (summarised at paragraph 5.3.5.4 above) as to this aspect of the appeal.

7.4 <u>The nature of the receipts pursuant to clause 3 of the publishing agreements</u>

Another part of the Taxpayer's case was that the payments pursuant to clause 3 of the publishing agreements were capital payments.

7.4.1 There was no evidence as to the nature of the Taxpayer's interest in the copyright with respect to 'pictorial A', 'pictorial B' and 'pictorial C' and, as the Board has already found, the Taxpayer had no right or title to the copyright in 'pictorial D' to sell to the Japanese publisher. Accordingly, the Taxpayer has failed to establish that these payments were made in consideration of the sale of one of its asset.

7.4.2 The Board agrees with the Revenue's submission (summarised in paragraph 5.3.5.4 above) as to the nature of these payments: they were no more than advance payments on account of the royalties to be paid on the basis of the actual sales of the works when published.

7.5 <u>The payments pursuant to clause 6 of the publishing agreements</u>

7.5.1 The amounts paid pursuant to the terms of clause 6 of the publishing agreements were not individually addressed by the Taxpayer's representative or the Revenue's representative at the appeal. The appeal proceeded on the basis that the OPRR included all of the payments made pursuant to the publishing agreements which belonged to the Taxpayer.

7.5.2 Pursuant to this clause the Japanese publisher was obliged to pay $34,000 for the 'duplicate negative film of ["pictorial A"]', $31,200 for the 'duplicate negative film of ["pictorial B"]', $30,000 for the 'duplicate negative film of ["pictorial C"]' and $12,200 for the 'duplicate negative film of ["pictorial D"]'.

7.5.3 Under clause 3 of the principal agreement the Taxpayer was to receive 'pictures' for the purpose of making the printing plates (presumably of the illustrations) for 'pictorial D' whereafter the pictures were to be returned to the copyright owners. The Taxpayer did not acquire the ownership of these 'pictures'; all the Taxpayer acquired was the right to use them for the limited

purpose of making the printing plates for the 'Hong Kong Chinese edition'. There was no evidence that the Taxpayer received any different rights with respect to the 'pictures' obviously supplied to enable publication of Hong Kong Chinese editions of 'pictorial A', 'pictorial B' and 'pictorial C'.

7.5.4 Pursuant to clause 5 of the principal agreement the copyright in any foreign language edition of 'pictorial D' negotiated by the Taxpayer was to be reserved to the copyright owners. Factually, clause 1 of each publishing agreement only conferred, upon the publisher a license to 'translate, publish and sell', globally, the Japanese language edition.

7.5.5. As the Board has found that the publishing agreement in respect of 'pictorial D' was entered into by the Taxpayer as agent for an undisclosed principal, the copyright owners, it follows that the sums received by the Taxpayer pursuant to clause 6 of this publishing agreement belong exclusively to the copyright owners and did not fall to be included as part of the receipts of the Taxpayer.

7.5.6 As would appear to be apparent from the tabulation in paragraph 1(3) of the determination, refer paragraph 2.12 above, the payments made by the Japanese publisher pursuant to clause 6 of the publishing agreement for 'pictorial D' were not included as receipts in the audited accounts of the Taxpayer.

7.5.7 The Taxpayer has not satisfied the Board that the position with respect to the other three 'pictorials' is different, the terms of the informal agreements are not in evidence, and the same tabulation would appear to indicate that the payments pursuant to clause 6 of the three relevant publishing agreements were not included as receipts in the audited accounts of the Taxpayer.

7.6 <u>The source of the receipts</u>

In view of the Board's findings as to the nature of the receipts the Taxpayer's submission as to source falls for consideration.

7.6.1 <u>The tests to determine source</u>

The Board accepts that the approach to be adopted in the determination of source is that set out by Hunter J in the <u>Sinolink</u> case. The appeal turns purely upon fact and the proper tests are those laid down by Atkin LJ in the <u>Smidth</u> case and the <u>Rhodesia Metals</u> case, and refer paragraph 7.6.4 below.

7.6.2 <u>The evidence as to source</u>

The facts available to the Board are:

7.6.2.1 Prior to December 1981 the Taxpayer had published the 'Hong Kong Chinese edition' of 'pictorial A'; this is evidenced from the correspondence referred to in the following sub-paragraph.

7.6.2.2 The Taxpayer received a letter from Japan, the produced copy of which was undated, enquiring as to the publishing of a Japanese language edition of 'pictorial A'. This letter was received in Hong Kong and answered from Hong Kong by the letter dated 30 December 1981, refer paragraphs 2.11.1 and 2.11.2 above.

7.6.2.3 The name of the person who signed the letter referred to in the preceding sub-paragraph and the name and address of the company on whose behalf he signed the letter are different to the name of the person, company and address of the Japanese party to the publishing agreements. There was no evidence as to the connection, if any, of this correspondent with the actual party to the publishing agreements.

7.6.2.4 The Taxpayer's audited accounts for its year ended 31 December 1981 contain:

7.6.2.4.1 A schedule of travelling expenses which includes an amount expended by two ladies in respect of a business trip to Japan. No evidence was adduced by the Taxpayer as to why these ladies went to Japan. The Board cannot assume that they negotiated the agreement signed on 11 May 1982 between 30 and 31 December 1981, refer the dates of the correspondence noted at paragraphs 2.11.1 and 2.11.2 above. The Board notes that the Taxpayer's tax computation, refer paragraph 3.l.l.7 above, does not add back this expense as a non-allowable deduction, that is an expense not incurred in or towards the making of Hong Kong taxable profits. Accordingly, the Board is obliged to accept that this visit had nothing to do with the publishing agreement dated 11 May 1982.

7.6.2.4.2 A schedule of legal fees, none of which was expended with respect to agreements relating to publishing.

7.6.2.4.3 'Overseas patent right receipts' of $20,000. Bearing in mind the chronology of events, it does not appear possible for these receipts to have been derived from the publishing agreements, unless it was a pre-contract prepayment, but there was no evidence as to this. Additionally, the first publishing agreement does not state that any part of the minimum guaranteed royalty, to be paid pursuant to clause 3, had been paid previously. It is also to be noted that the manufacturing statement records a patent right receipt in the previous accounting period of $8,000 which was not referred to as connected with the four 'pictorials'.

7.6.2.5 The first publishing agreement, which is with respect to 'pictorial A', is dated 11 May 1982.

7.6.2.6 On 22 September 1982 the marketing manager of the Taxpayer spoke and wrote to a Mr X, the letter being addressed to him at the offices of a Hong Kong corporation in Tsuen Wan, refer paragraph 2.11.3 above, referring to the intended publication (by the Japanese publisher who entered into the publishing agreements) of 'pictorial B' 'at the end of' 1982 and of 'pictorial C' and 'pictorial D' 'early' in 1983, (although it is to be noted that the principal agreement, which relates to 'pictorial D', had yet to come into existence) and accepting the royalty which, apparently, Mr X had offered to the Taxpayer with respect to these three 'pictorials' during the telephone conversation.

7.6.2.7 The second publishing agreement, which is with respect to 'pictorial B', is dated 20 December 1982 and specifies as the royalty that accepted by the letter dated 22 September 1982. The second clause 4 of this agreement also fixes the royalty for 'pictorial C' and 'pictorial D' at the rate stated in that letter.

7.6.2.8 The Taxpayer's audited accounts for its year ended 31 December 1982 contain:

7.6.2.8.1 a schedule of travelling expenses, none of which relate to travel to Japan;

7.6.2.8.2 expenditure of $7,114.30 on legal fees but, unlike the previous year, there is no schedule as to the nature of this expenditure; and

7.6.2.8.3 'Overseas patent right receipts' of $58,115.76.

7.6.2.9 The third publishing agreement, which is with respect to 'pictorial C' is dated 28 June 1983 and specifies as the royalty that accepted by the letter dated 22 September 1982 and specified in the second clause 4 of the publishing agreement referred to in paragraph 7.6.2.7 above. Clause 4 of this agreement also fixes the royalty for 'pictorial D' at the rate stated in that letter.

7.6.2.10 The principal agreement, which is with respect to 'pictorial D', is dated 16 August 1983. The history of this agreement is set out in paragraph 2.7 above.

7.6.2.11 The Taxpayer's audited accounts for its year ended 31 December 1983 contain:

7.6.2.11.1 a schedule of travelling expenses, none of which relate to travel to Japan;

7.6.2.11.2 no expenditure on legal fees; and

7.6.2.11.3 'Overseas patent right receipts' of $197,302.94.

7.6.2.12 The fourth publishing agreement, which is with respect to 'pictorial D', is dated 11 January 1984 and specifies the royalty as that accepted by the letter dated 22 September 1982 and specified in the second clause 4 of the publishing

agreement referred to in paragraph 7.6.2.7 above and in clause 4 of the publishing agreement referred to in paragraph 7.6.2.9 above.

7.6.2.13 The Taxpayer's audited accounts for its year ended 31 December 1984 contain:

7.6.2.13.1 a schedule of travelling expenses, none of which relate to travel to Japan;

7.6.2.13.2 expenditure of $1,587.50 on legal fees, but without any particulars; and

7.6.2.13.3 'Overseas patent right receipts' of $28,012.05.

7.6.3 Conclusions to be drawn from the facts and documents

What can be deduced from the established facts and the documents in evidence is that:

7.6.3.1 On 11 May 1982, that is subsequent to the letter of 30 December 1981, the first publishing agreement came into existence. There is no evidence that this agreement was a direct result of this letter. The Taxpayer's audited accounts for its year ended 31 December 1982 do not include any travel expenses between Hong Kong and Japan. If, as the Taxpayer submitted, the publishing agreements were negotiated and signed in Japan, one would expect to find the expenses incurred detailed in the audited accounts and the related tax computation.

7.6.3.2 On 22 September 1982, the Taxpayer was communicating with a Hong Kong corporation, with offices in Tsuen Wan and which company the Taxpayer clearly regarded as competent to represent the Japanese publisher. The facts referred to in paragraphs 7.6.2.7, 7.6.2.9 and 7.6.2.12 above would appear to establish this. The purpose of this letter have been noted in paragraph 7.6.2.6 above and commented on in paragraphs 7.6.2.7, 7.6.2.9 and 7.7.2.12 above.

7.6.3.3 In the years in which the second, third and fourth publishing agreements were signed the Taxpayer's audited accounts do not include any travelling expenses between Hong Kong and Japan. This fact, together with the degree of similarity between all four publishing agreements, is such as to indicate that the Taxpayer and the Japanese publisher would appear to have agreed that the terms of the first publishing agreement were suitable for the three subsequent publishing agreements.

7.6.3.4 There is no evidence before the Board that any representative of the Taxpayer went to Japan to negotiate any of the publishing agreements or that an agent for the Taxpayer negotiated all or any of them in Japan. Apart from the three letters, refer paragraphs 2.11.1, 2.11.2 and 2.11.3 above, the only evidence is the publishing agreements themselves.

7.6.4 The tests to be applied

The activities which produced the income the subject matter of this appeal fall under the headings set out by Hunter J at page 132 of the report of the Sinolink case, namely:

7.6.4.1 Pre-contract preparation and management.

7.6.4.2 The making of the contracts with the copyright owners.

7.6.4.3 The making of the publishing agreements.

7.6.4.4 Post-contract performance and management.

7.6.5 Application of the tests to the facts

7.6.5.1 Pre-contract preparation and management

7.6.5.1.1 There was no evidence as to where the Taxpayer's negotiations with the copyright owners with respect to the informal agreements took place.

7.6.5.1.2 The principal agreement was patently negotiated by correspondence.

7.6.5.1.3 The Taxpayer incurred no travelling expenses for visits to Japan in any of the years in which the publishing agreements came into being.

The Board is obliged to find that the Taxpayer has failed to establish that any of the pre-contract steps taken by the Taxpayer to secure its agreements with the copyright owners and the publishing agreements took place outside Hong Kong.

7.6.5.2 The making of the agreements with the copyright owners

Because of the limited scope of the issue at the appeal as a result of the Board's findings as to the nature of the receipts, the place where these agreements were made is not relevant. Suffice it to say that there was no evidence that the informal agreements were entered into in the PRC and the evidence as to the principal agreement was that the Taxpayer accepted the copyright owners' offer in Hong Kong.

7.6.5.3 The making of the publishing agreements

7.6.5.3.1 There was no evidence as to where and by whom the publishing agreements were prepared or how and where they were signed and exchanged.

7.6.5.3.2 The absence of any expense in the nature of travel in the years in which the publishing agreements were signed would indicate that the Taxpayer did not send any one to Japan for the purpose of entering into off-shore contracts.

The Taxpayer has failed to satisfy the Board that the publishing agreements were made off-shore Hong Kong.

7.6.5.4 Post-contract performance and management

7.6.5.4.1 There was no evidence as to what, if anything, the Taxpayer did once the publishing agreements were signed.

7.6.5.4.2 The Taxpayer did not have a contractual obligation to deliver the Chinese language text to Japan for translation into Japanese.

7.6.5.4.3 The Taxpayer had the contractual obligation to deliver the 'duplicate negative film' but, in the words of clause 6 of each publishing agreement, the obligation was to arrange for them 'to be sent' to the Japanese publisher.

7.6.5.4.4 The Taxpayer would be obliged to account to the copyright owners for the price received in respect of the 'duplicate negative film' for 'pictorial D', refer paragraph 7.5.5 above and, probably, for the other three 'pictorials', refer paragraph 7.5.7 above, possibly issue receipts for the royalty payments received from the Japanese publisher, effect payment of one half of those payments to the copyright owners, at least in so far as 'pictorial D' is concerned, and pursue any affidavit as to the numbers printed and sold, refer clause 11 of each publishing agreement.

The overwhelming inference to be drawn is that all of the foregoing would be done exclusively in Hong Kong.

7.6.6 Conclusion

The Board finds that, on the application of the tests laid down by Hunter J in the Sinolink case, the Taxpayer's receipts from the publishing agreements arose in and were derived from Hong Kong.

8. DECISION

For the reasons given the Board dismisses this appeal in its entirety.