Case No. D52/88

Profits tax – source of profits – fees from offshore licensing activities – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: H F G Hobson (chairman), Karl Kwok Chi Leung and J D Mackie.

Dates of hearing: 3, 6, 7, 8 and 10 June 1988.
Date of decision: 29 November 1988.

The taxpayer company carried on the business of licensing films which had been produced by its parent company. This activity was carried on pursuant to license agreements which had been entered into between the taxpayer and its parent in Hong Kong.

The taxpayer granted sub-licences for use of these films both in and outside Hong Kong. The issue before the Board of Review was whether the fees which were received by the taxpayer from sub-licensing films for use outside Hong Kong had a Hong Kong source.

Generally, the taxpayer would conduct negotiations with its sub-licensees outside Hong Kong. Activities performed by the taxpayer in Hong Kong included preparing and sometimes signing contracts, receiving payments and duplicating films on to video tape for transmission to sub-licensees. Sometimes, at a sub-licensee's request, the taxpayer would charge a separate fee for such duplicating and reduce the sub-licensee fee accordingly. The taxpayer delivered films to its sub-licensees in Hong Kong.

The IRD assessed the taxpayer to profits tax with respect to the sub-licensing fees received by it. The taxpayer appealed.

Held:

The sub-license fees were sourced outside Hong Kong and therefore were not subject to profits tax.

(a) The source of the sub-licensing fees was the place where the sub-licensees were entitled under their sub-licences to exercise their rights under those sub-licences. These consisted of the rights to exhibit, sell and rent out the films.

(b) This conclusion was not affected merely because the copyright in the films might not be protected under the laws of the sub-licensee's jurisdiction.

(c) The duplication of films in Hong Kong for the purpose of delivering them to sub-licensees was merely incidental to the taxpayer's core activity of sub-licensing those films.

Appeal allowed.

[Editor's note: The Commissioner of Inland Revenue has filed an appeal against this decision.]

Cases referred to:

British United Shoe Machinery (SA)(Pty) Ltd v CT (South Africa) (1964) 26 SATC 163
CIR v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85
Rhodesia Metals Ltd v CT (South Africa) [1940] AC 774
Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127

Adela Au for the Commissioner of Inland Revenue.
Gladys Li instructed by Deacons for the taxpayer.

Decision:

This appeal by the Taxpayer company was against profits tax assessments for the four years 1980/81 to 1983/84. The original appeal included three earlier assessment years but, as the objection to these was abandoned, we need not consider them. The assessments in relation to the two years 1980/81 and 1981/82 were the subject of an application under section 70A of the Inland Revenue Ordinance to correct errors which application had been refused by the assessor whose refusal was upheld by the Commissioner of Inland Revenue. However, the principles concerning those assessments and the two following years are the same.

The issue is whether certain profits accruing to the company from films exhibited by its licensees outside Hong Kong were subject to profits tax.

Miss Gladys Li of Counsel represented the company and Miss Adela Au, Crown Counsel, appeared for the Commissioner.

1. FACTS

Of the facts agreed between the parties, the following represent only a summary of the essential ones and include facts not in dispute.

1.1 The company was incorporated in Hong Kong. In its profits tax returns, the company described the nature of its business as 'Sales of Films' (up to and including 1981/82) and 'Licensing of Films' (1982/83 and 1983/84). The company's ultimate holding company is X Company, which is also incorporated in Hong Kong.

1.2 By a letter dated 28 August 1980 ('the 1980 Letter'):

(a) X Company appointed the company to be 'its sole and exclusive agent for the distribution of regional rights of foreign films which X Company may acquire from time to time' in return for which the company would pay X Company 75% of the gross sales (the agreement actually expressed it as X Company paying 25% commission to the company).

(b) In addition, X Company gave the company the international distributorship of 'all films produced … by X Company', for which the company was to pay X Company a royalty of 40% of the gross selling prices.

1.3 The distributorship in (a) above referred to films not produced by X Company ('licensed films', see 1.4(a) below) but this activity is not material to this appeal. The distributorship in (b) above was concerned with materials produced by X Company itself. These materials took the form of films as well as home videos.

1.4 By an agreement dated 1 June 1981 ('the 1981 Agreement'), X Company:

(a) appointed the company its exclusive agent to grant sub-licences to use licensed films. These are the equivalent of 1.2(a) above and do not concern us; and

(b) granted the company the exclusive right outside Hong Kong (and non-exclusive rights in Hong Kong, which is not relevant to this appeal) to:

- copy, adapt and cause to be heard in public X Company films, that is those for which X Company held the entire copyright, (in effect the same as 1.2(b) above),
- exploit them, and
- to grant sub-licences.

1.5 The 1981 Agreement superseded the 1980 Letter as from 16 January 1981, and remained in force throughout the material period.

1.6 The following shows the income earned by the company from the rights relating to X Company films:

Year of

Assessment	1980/81 $	1981/82 $	1982/83 $	1983/84 $
Gross income received from licensing X Company films outside Hong Kong	3,340,245	7,116,499	15,375,274	31,453,690
Gross income received from licensing X Company films in Hong Kong	nil	nil	6,000	5,000

Of these the company claims that the first line of figures (that is, gross income received from licensing X Company films outside Hong Kong) is not subject to profits tax.

1.7 X Company's copyright, and the rights of the company as a licensee by virtue of the 1980 Letter and the 1981 Agreement, were protected in Thailand, UK, Canada, Australia, France, West Germany, USA, Malaysia and Singapore by the Berne Copyright Convention and/or the Universal Copyright Convention or the Imperial Copyright Act 1911 or the Copyright Act 1969 of Malaysia.

2. TESTIMONY

Two witnesses gave evidence. From their testimony, which – though sometimes difficult to follow due to jargon – we felt was truthful, and from documentary evidence referred to by them, we make the following additional findings of fact.

2.1 The greater part of the company's revenue came from the exploitation of X Company films.

2.2 When exploring new markets, though there may be initial correspondence with 'brokers', normally the company's personnel would go to the country concerned to show samples, work out the price and details and draw up the basic terms of the contract. They would then return to Hong Kong and despatch a sub-licensing contract and receive back a signed copy. Sometimes the company signed before despatching the contract, and sometimes it was sent unsigned: either way, the company considered itself committed to the customer and would not deal with a rival.

2.3 The price quoted by the company to a potential customer would be inclusive not only of the sub-licence fee but would also include the cost of any facilities

the customer might require. Prior to 1982, in the case of home videos the price to the customer contained no charge for tape transfer facilities (that is, duplicating the film from the master on to video cassettes) nor for the video cassettes themselves because the customer would undertake that himself in Hong Kong with his own tapes and machines. In 1982, the company set up its own studio for that purpose but the cost was incorporated in the license fee payable by the customer. However, to mitigate local taxes some, but not many, customers asked the company to split the invoice into a fee for the sub-licence and a charge for the facilities, and the company would oblige. Where dubbing was asked for by the customer, the company would sub-contract that task out, often to a sister company. The company never did any dubbing itself.

2.4 In the case of X Company films (as distinct from home videos) intended to be publicly displayed, (that is, 'displays'), prior to 1982 the company did sometimes charge separately for the sub-licence and the facility without any request to do so by the customer.

2.5 There was no pattern to the manner in which customers paid the company's invoices. Sometimes cheques, drafts, telex transfers and even cash brought to Hong Kong were used to effect payment.

2.6 The contracts for some pre-1982 display work stipulated that facility charges would be charged separately though, in many instances, no such charge was made because the customer did the work himself (see 2.3 above).

2.7 The normal practice for home videos was to supply the customer with one duplicate tape, leaving the customer to do his own copying as many times as he wished. Some home videos were played by the customer to theatre audiences.

2.8 The company was not licensed by any entity other than X Company to carry on a similar business.

2.9 The company's licensing fee charged to the customer was based upon what the market in the customer's territory could bear. Hence, the cost of any dubbing work borne by the company and of duplicating played no part in fixing this fee.

2.10 In setting-off costs (referred to in the company's accounts as 'direct costs') against income, the company deducted (a) the 40% royalty on the gross of the invoices payable to X Company, unless the charges were divided between license fee and facilities in which case the 40% was based on the license fee less the actual cost attributed to actual facilities, and (b) the notional charge for facilities if the sub-license contract concerned incorporated a split or, if there was none, then on actual costs attributed to that contract. In determining actual costs, the company adopted the same rates that X Company itself attributed to the same work.

2.11 The company kept its records and accounts attributable to the business it conducted in relation to licensed films (see 1.2(a) and 1.4(a) above) separate from those relating to the activities the subject of this appeal.

2.12 The company did make profits out of providing facilities. However, this only occurred where the customer had asked for a figure to be shown separately for facilities and that figure exceeded the company's actual costs.

2.13 Both Counsel referred us and the witnesses to detailed accounts. However, we think it is unnecessary to refer to them since they have no direct bearing on the principles involved.

3. THE COMPANY'S SUBMISSIONS

3.1 It was the company's case that the source of the company's revenue for the amounts referred to in para 1.6, derived from sub-licensing, lay outside Hong Kong and hence were not taxable under section 14 of the Inland Revenue Ordinance.

3.2 Miss Li referred us to five cases. However, we feel it is necessary to deal with only two of them to illustrate her argument:

(a) The Privy Council case of Rhodesia Metals Ltd v Commissioner of Taxes (South Africa) [1940] AC 774 was concerned with the purchase of and development of mining rights in Southern Rhodesia by one English company (the appellant) whose liquidator sold the rights at a profit to another English company pursuant to an agreement negotiated and concluded in England, the purchase price also being paid in that country. The question for the Privy Council was whether the profit arose from a business or trade carried on in Southern Rhodesia (as that territory's tax authorities contended). In delivering the Privy Council's judgment, after reaffirming that 'source means not a legal concept, but something which a practical man would regard as a real source of income', Lord Atkin said this:

> 'Whatever may be the right view of the source of receipts derived from trading in commodities, their Lordships find themselves dealing with a case where the sole business operation of an English company is the purchase of immovable property in Southern Rhodesia and its development in that territory for purposes of transfer in that territory at a profitable price. The company never adventured any part of its capital except on that or those immovables. As a hard matter of fact the only proper conclusion appears to be that the company received the sum in question from a source within the territory, namely, the mining claims which they had acquired and developed there for the very purpose of

> obtaining the particular receipt. Their Lordships will therefore humbly advise His Majesty that this appeal should be dismissed.'

The Privy Council therefore found against the taxpayer.

Miss Li submitted that factually there was a strong analogy between that case and the circumstances of the case before us.

(b) In British United Shoe Machinery (SA)(Pty) Ltd v Commissioner of Taxes (South Africa) (1964) 26 SATC 163, a South African company sold or leased shoe making machinery, some of which were leased to lessees in Rhodesia. The Rhodesian tax authorities assessed the profits from those leases to tax on the grounds that they were sourced in that territory. The Court of Appeal, after examining much relevant case law, upheld the assessment. Certain passages on p 167 of their judgment are pertinent but it will suffice to quote one passage, namely:

> 'It is obvious that there cannot be an inexhaustible market in which to lease machinery used in the manufacture of footwear. And if a lessor of such machinery has such quantities of it for hire that he can hire it out not only in his own country but in an adjoining country, it seems to me that it is an inescapable conclusion that he means to make money through the use of that machinery in that other country. If that is so, it does not seem to me to matter that would be users of the machinery have to go to the lessor to get it, and have to pay to take it to where they want to use it. The lessor is opening up another market for his hiring activities. And when the property produces income in that other market the source of that income is I consider where the market is. I consider that it is clear that with property of this nature, and leases of so long duration so that the emphasis is on the property and not on the business of the lessor, the source of income derived from the property is where the property is used.'

3.3 Miss Li drew our attention to certain passages in the Copyright Act 1956 in relation to the rights of an exclusive licensee (which we were led to assume would be very much the same for those non-Hong Kong countries referred to in para 1.7), the effect of which is to give the company the same rights as X Company in those countries where the company granted sub-licences.

4. THE COMMISSIONER'S SUBMISSIONS

4.1 Miss Au argued that the facts showed that the income in dispute was generated and originated in Hong Kong. In this respect, she noted that the 1980 Letter and the 1981 Agreement were entered into in Hong Kong between two Hong Kong companies, that X Company supplied the films to the company in Hong Kong,

that the marketing of the sub-licences was conducted from Hong Kong, and that in some cases the sub-licence contracts were actually signed in Hong Kong. Moreover, the facility services were rendered in Hong Kong and probably the Hong Kong courts would have exclusive jurisdiction.

4.2 Accordingly, on the basis of the operations test, she submitted that the source of the profits is Hong Kong.

4.3 Miss Au referred us to passages in CIR v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85 and Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127 in support of this argument.

4.4 Miss Au pointed out that, in so far as Taiwan was concerned, no copyright protection existed.

5. CONCLUSIONS

5.1 On the evidence before us, we have no hesitation in finding that the profits accruing to the company from the fees derived from the sub-licensing were sourced in the countries in which the sub-licensees were entitled by virtue of the sub-licensing contracts to exercise their particular rights, be they the sales or letting out of home video cassettes or the exhibition in theatres owned or let by the customer.

5.2 The licence granted to the company by the 1980 Letter and the 1981 Agreement vested in the company rights over intangible property, namely ephemeral visual images projected on a screen, which rights by the terms of the relevant documents could only be exercised outside Hong Kong. Hence, the intangible property itself so far as the company was concerned could only subsist outside Hong Kong. It was those rights which were sub-licensed.

5.3 So far as all the countries referred to in 1.7 are concerned, we believe that the local laws themselves reinforce the opinion expressed in 5.2 because the protection afforded by their local laws, understandably, was confined to their own territories.

5.4 So far as Taiwan is concerned, the lack of protection did not per se strip the company of the right given to the company to procure exhibitors there. It merely meant that the customer took a risk that another party might tape from a broadcast or duplicate from a leased or sold video cassette, whether done or obtained in Taiwan, Hong Kong, or some other country where the film or broadcast had appeared previously. In so far as a Taiwan customer might breach the terms of his sub-licence, theoretically the company could perhaps sue in Hong Kong for breach of contract, not breach of copyright. However, we believe the point is academic because presumably the company would not

release its tapes until it was sure it would be paid and presumably the company would do its best to minimize the risks. In any event, its fees would reflect the extent or otherwise of the risk to the customer; for example, if there was a belief by the customer that a pirate would be first in the market, the fee would be less.

5.5 We believe the foregoing conclusions are in line with the practical hard matter of fact approach but consider the Rhodesia Metals case (above, which was likewise concerned with the exploitation of rights) supports this belief.

5.6 As regards the profits accruing from the facility services, though we recognize that these services were carried out in Hong Kong, nonetheless the evidence showed that the services did not, as a matter of physical necessity, have to be done by the company (nor for that matter was it imperative they be done in Hong Kong – though there is no evidence to suggest that the first duplication from the master tape was done abroad). We therefore find that such services were simply an incidental adjunct to the core activity of sub-licensing to overseas customers. Accordingly, we find that these profits are likewise not taxable.

We therefore allow this appeal and direct that all four assessments, including those the subject of the section 70A application, be referred back to the Commissioner for revision in accordance with our findings. We understand that the Revenue did reserve its position in relation to the accuracy or propriety of the figures contained in para 1.6 above and do not therefore direct that these figures themselves necessarily be adopted. In this regard, we are prepared to hear the parties on the figures if they cannot reach mutual resolution.