Privy Council Appeal 28 of 1991

The Commissioner of Inland Revenue *Appellant*

v.

HK-TVB International Limited *Respondent*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 20TH JULY 1992

Present at the hearing:-

LORD TEMPLEMAN
LORD GOFF OF CHIEVELEY
LORD JAUNCEY OF TULLICHETTLE
LORD LOWRY
SIR CHRISTOPHER SLADE

*[Delivered by **Lord Jauncey of Tullichettle**]*

The issue in this appeal is whether profits accruing to the taxpayer company, HK-TVB International Limited, ("TVBI") in the four years of assessment 1980/81 to 1983/84 arose in or derived from Hong Kong. If they did, they were assessable to Hong Kong profits tax but if they did not they escaped assessment.

Section 14 of the Inland Revenue Ordinance which occurs in Part IV thereof provides:-

> " Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in [Hong Kong] in respect of his assessable profits arising in or derived from [Hong Kong] for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

Section 2 which is the interpretation clause provides *inter alia*:-

> '"Profits arising in or derived from Hong Kong' for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from

business transacted in Hong Kong, whether directly or through an agent;"

TVBI was incorporated in Hong Kong on 17th June 1975 and is a subsidiary of another Hong Kong company, HK-TVB Limited ("TVB") which makes or acquires films in various Chinese dialects. TVB has the copyright in these films in a number of countries where Chinese is spoken and owns films which are either telecast or home videos. By clause 6 of an agreement dated 1st June 1981 ("the agreement") TVB granted certain rights to TVBI in the following terms:-

"TVB hereby grants to TVBI, which accepts, the sole and exclusive right outside Hong Kong and the non-exclusive right in Hong Kong throughout the life of this Agreement and upon the terms and conditions of parts 2 and 3 hereof:

(a) to copy, adapt, and cause to be seen and heard in public (otherwise than by means of wireless or cable TV transmissions in Hong Kong) all TVB Films,

(b) to exploit all derivative rights in TVB Films (excluding the hotchpot programmes) and

(c) to grant sub-licenses to others to do the acts set out in paragraphs (a) and (b) above for periods not exceeding 5 years unless TVB's prior written consent ..."

It was provided in clause 10 of the agreement that TVBI would pay to TVB a license fee equivalent to 40% of the aggregate revenues received and receivable by it from the grant of the sub-licenses. Thereafter TVBI exercised their contractual rights under clause 6(c) but not those under (a) or (b) of that clause.

A very considerable number of sub-licenses which were normally for a period of six to twelve months were granted during the relevant years of assessment and the aggregate profit therefrom during these years amounted to some HK$57 million. The precise circumstances surrounding the granting of individual sub-licences necessarily varied but in general TVBI sent representatives abroad to solicit business and to negotiate with potential customers. The price to be paid for the sub-licences was either agreed at that time or subsequently by letter or telex and the sub-licence was then prepared in Hong Kong and sent to the customer for signature. On occasion the sub-licence was signed by both parties in the foreign country, and on other occasions the whole negotiations were concluded by telex with no representative of TVBI visiting the foreign customer. The sub-licensee paid a fixed fee, unrelated to profits earned by him, which was either payable as a lump sum or by instalments. Payment was made in Hong Kong. In addition to granting sub-licences TVBI from time to time

provided facilities for the duplication of films from the master film onto video cassettes and for dubbing which was carried out by sub-contractors. All the work in connection with these facilities was carried out in Hong Kong and the cost thereof was included in the sub-licence fee unless a customer asked specifically for a separate invoice. Upon receipt of the executed sub-licence from the customer the film was dispatched to him from Hong Kong.

The Commissioner of Inland Revenue confirmed assessments to tax on the profits arising from TVBI's sub-licencing operations and TVBI appealed to the Board of Review. After a hearing lasting five days the Board of Review allowed the appeal and referred the four assessments back to the Commissioner for revision. The Commissioner's appeal to the High Court by stated case was allowed by Godfrey J., but on appeal the decision of the Board of Review was affirmed by the Court of Appeal. The Commissioner now appeals to Her Majesty in Council.

The Board of Review considered that the issue for their decision was whether certain profits accruing to the company from films and programmes exhibited by its customers outside Hong Kong were exigible to profits tax. After making findings in fact which are broadly summarised in the second paragraph of this judgment the Board determined *inter alia*:-

(1) that the fees derived from the sub-licencing were sourced in the countries in which the sub-licensees were by their contracts entitled to exercise the particular rights and

(2) that the 1981 agreement vested in TVBI rights over intangible profits, which rights could only be exercised outside Hong Kong.

The question of law for the opinion of the High Court stated by the Board of Review was whether, on the facts agreed and proved, the relevant profits for the years of assessment in question did not arise in or derive from Hong Kong from a trade or business carried on by TVBI in Hong Kong. Godfrey J. answered the question by concluding that the Board of Review were incorrect in law in holding that the relevant profits did not arise in or derive from Hong Kong. He concluded that on a correct analysis TVBI's operations which generated the relevant profits were operations carried on in and from Hong Kong. He went on to say "the time has come to make it clear that it is only where a taxpayer has established the existence of a profit-generating operation carried on by him outside Hong Kong that he can hope to escape the charge to profits tax imposed by section 14".

Between the date of Godfrey J.'s decision and the hearing in the Court of Appeal the case of *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.* [1991] 1 A.C.

306 was decided by this Board. In the light of that decision the Court of Appeal, in a short judgment, concluded that TVBI's rights from their sub-licencing operations neither arose in nor derived from Hong Kong. Kempster J.A. said:-

> "The taxpayer here has carried on marketing activities outside Hong Kong resulting in agreements for the sale or sub-licensing of intellectual property rights also exercisable only outside the Colony. The consideration is paid because the purchasers and sub-licensees are entitled to exercise these rights. Essentially the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong. Alternatively, the profit was earned by the exploitation of property assets and arose or was derived from the places where those assets were when sold or licensed and remain; all outside Hong Kong."

The issue in *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.* was also whether certain profits accruing to a company trading in Hong Kong arose in or derived from Hong Kong, but the facts were somewhat different. The practice of the taxpayer bank was to invest its day to day surplus holdings in foreign currencies on certificates of deposit which were issued by overseas banks agreeing to repay a fixed sum of money on a fixed date at a fixed rate of interest but which, unlike fixed deposits, were readily marketable at any time before maturity at a price which reflected the accrued interest element up to the date of sale. During the three relevant years of assessment there were markets for certificates of deposit in London and in Singapore but not in Hong Kong. The taxpayer bank's foreign exchange department continually monitored the day to day situation and decided what certificates should be purchased and at what time before maturity they should be sold. Instructions for these purposes were given through correspondent banks in London and Singapore. The funds used in and accruing from these transactions were debited and credited to accounts of the taxpayer bank with overseas banks and it was the profits from these transactions which the Commissioner sought to tax.

Before this Board the Commissioner advanced two main submissions, namely:-

(1) that the business of the bank was one and indivisible since all the profit earning operations were directed from Hong Kong by staff therein employed, no overseas branch of the bank was involved and the funds employed in the purchase of the certificates of deposit arose from the carrying on of the business in Hong Kong, and

(2) that in any event, even if the sale and purchase of certificates of deposit failed to be treated as separate operations, nevertheless the profits from these operations arose in Hong Kong. The investment

decisions were taken in Hong Kong and the funds used in the purchase derived from Hong Kong depositors.

This Board rejected both these submissions and held that the profits did not arise in or derive from Hong Kong. In rejecting the first submission Lord Bridge of Harwich, who delivered the judgment of the Board, said at page 318:-

> "Their Lordships cannot accept this submission. Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be 'from such trade, profession or business', which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be 'profits arising in or derived from' Hong Kong. Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not. On the commissioner's submission the requirement of condition (3) would be otiose, since it would be sufficient to show that profits were earned by a business carried on in Hong Kong to make them taxable."

He then went on to reject a submission that the third condition was only effective to except a Hong Kong profits taxpayer from liability to tax on the profits of an independent business carried on by him overseas. Later, in a passage to which much argument was directed in this appeal, Lord Bridge at page 322-3 said:-

> "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

The case of *Smidth & Co. v. Greenwood* [1921] 3 K.B. 583 was cited in the *Hang Seng Bank* case and their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin L.J. in that case and in particular the passage at page 593 when he said:-

> "I think that the question is, Where do the operations take place from which the profits in substance arise?"

Thus Lord Bridge's guiding principle could properly be expanded to read "One looks to see what the taxpayer has done to earn the profit in question and where he has done it". Further their Lordships have no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong. In the *Hang Seng Bank* case the two transactions which threw up the profit, namely the purchase and re-sale of the certificates of deposit, both took place outside Hong Kong and this Board held that the profits did not arise in or derive from Hong Kong, notwithstanding the fact that all the instructions to buy and sell originated in Hong Kong and that there was no independent branch office interposed between the head office in Hong Kong and the following transactions.

Applying Lord Bridge's guiding principles it is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to TVBI. Those transactions were two-fold, namely, the acquisition of the exclusive rights of granting sub-licences together with the relevant films and the grant of those sub-licences together with provision of the film by contracts with individual customers. Mr. Kentridge, for the Commissioner, referred to seven factors which, he submitted, demonstrated that TVBI's business and its profits were carried on in and were derived from Hong Kong. These factors were:-

(1) Its organisation which acquired the films and the exclusive overseas rights therein was in Hong Kong;

(2) Its sales organisation was in Hong Kong;

(3) The representatives who were sent abroad were part of the Hong Kong sales organisation;

(4) The sub-licences were drawn up in Hong Kong, according to Hong Kong law, and were dispatched from Hong Kong;

(5) The films were either delivered in or dispatched from Hong Kong;

(6) The films at the expiry of the sub-licence period had to be returned to Hong Kong or were destroyed; and

(7) Payments for the grant of the sub-licences were received in Hong Kong.

He further submitted that the owner of an incorporeal right did not derive his profits from the place where a sub-licensee, who was neither an agent nor joint adventurer, of these rights exploited them itself.

Mr. Park, for TVBI, argued that there were two alternative approaches to the problem:-

(1) TVBI provided a service in an overseas territory, say Vancouver, by sub-licensing in Vancouver, or

(2) TVBI exploited property assets by sub-licensing rights which were only capable of use in Vancouver.

The service, Mr. Park argued, could either consist in the grant of a sub-licence which enabled the operator to do in Vancouver what he could not otherwise lawfully do or could consist in the refraining by TVBI from stopping the grantee doing what he could otherwise be stopped from doing. The place where that service was performed was the place where the sub-licensee did what the grant enabled him to do without being stopped by TVBI. In arguing for the provision of a service Mr. Park was seeking to bring TVBI's operations within Lord Bridge's example in the *Hang Seng Bank* case of rendering a service (see page 323A). Their Lordships reject this argument. Where a resident in country A grants in that country the right in country B to exercise intellectual property rights which he has therein acquired by registration or application he does not render a service in country B by the grant. Nor does he render a service in country B or anywhere else by refraining in consequence of the grant from taking preventive action against the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity. When Lord Bridge referred to the rendering of a service he no doubt had in mind the sort of service rendered by the salvage done in *Commissioner of Inland Revenue v. Hong Kong and Whampoa Dock Company Limited* (1960) 1 HKTC 85 which was held to have been rendered outside Hong Kong. Another example of rendering a service outside Hong Kong could be the oversight by a Hong Kong based engineer of a civil engineering project in another country.

In developing his argument that TVBI were exploiting property assets which were only capable of use abroad Mr. Park sought to draw an analogy between letting a property which was referred to by Lord Bridge at page 323A in the *Hang Seng Bank* case and licensing of intellectual property rights. In the former case the profits arose where the property was situated and in the latter case where the rights were exercisable. Their Lordships consider this to be a false analogy, since it presupposes that intellectual property rights have a

situs similar to immovable property. In the latter case profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are made in the country of residence of the taxpayer (*Liquidator, Rhodesia Metals Limited v. Commissioner of Taxes* [1940] A.C. 774). It by no means follows, however, that intellectual property rights exercisable only in one country are to be equiparated to immovable property in that country. *Rhodesia Metals* case was referred to in the *Hang Seng Bank* case and it follows that when Lord Bridge used the words "place where the property was let" he must have been referring to the place where the property let was situated and not to the place or places where the lease happened to have been signed.

Mr. Park went on to argue that there were three phases in the operations carried out by TVBI, namely:-

(1) the pre-control phase where business was solicited abroad,

(2) the making of the contracts, and

(3) the performance of the contract throughout the stipulated period of duration in the overseas country by refraining from taking action there against the sub-licensee.

This approach ignores the fact that TVBI first had to acquire the right to grant sub-licenses. It also assumes that TVBI's forbearance from taking action in the overseas country was productive of profit to TVBI in that country - an assumption which their Lordships are not prepared to make. If a company hires out equipment for a given time on payment of a fixed fee, its profit derives from the contract of hire and not from its continued forbearance from seeking to recover that equipment during the contract period. Forbearance in the overseas country would be equally relevant to a grant to another Hong Kong company of rights to exhibit in that country - a situation which could hardly escape the operation of section 14.

Their Lordships consider that it is a mistake to try and find an analogy between the facts in this appeal and the example given by Lord Bridge in the *Hang Seng Bank* case. The circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that TVBI, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by

granting sub-licences to overseas customers. The relevant business of TVBI was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee. Their Lordships therefore consider that the profits accruing to TVBI on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14.

In the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance. Counsel for the Commissioner was able to refer to three cases only in which the source of profits had been held not to be in the principal place of business of the taxpayer. In *Commissioner of Income Tax, Bombay Presidency and Aden v. Chunilal B. Mehta of Bombay* (1938) L.R. 65 Ind. App. 332 a broker in Bombay entered into future delivery contracts for the purchase and sale of commodities in various foreign markets with parties outside British India, in which no delivery was ever given or taken, and the profits flowing from such contracts were not received in British India. This Board held that in the particular circumstances - the contracts having been neither framed nor carried out in British India - the profits derived from the contracts did not there accrue or arise. The circumstances were thus very similar to those obtaining in the *Hang Seng Bank* case. In *Commissioner of Inland Revenue v. The Hong Kong & Whampoa Dock Company Limited* (1960) 1 HKTC 85 the appellants, in response to a request from the owners, sent a tug to salvage a vessel stranded on a foreign island. The tug refloated the vessel, towed her to a sheltered anchorage where she was made fit for the tow to Hong Kong, and thereafter towed her for four days to docks in Hong Kong. The Supreme Court (Appellate Jurisdiction) held that the profits from the salvage operation were not "profits arising in or derived from the Colony" within the meaning of section 14(1) of the Inland Revenue Ordinance. Reece J. at page 116 said:-

> "Here the contract of salvage was entered into in the Paracels and all the work of refloating and putting the vessel into a condition to be towed to Hong Kong and nearly all the tow, except for the last three miles, were completed beyond the territorial limits of Hong Kong and consequently I take the view that the profits must be said to arise outside of Hong Kong rather than inside."

The third case is that of the *Hang Seng Bank*.

Turning to the decisions of the Board of Review and in the courts below, it appears that the Board of Review, by posing the question in their decision in the manner

which has already been referred to, assumed that TVBI's profits accrued from exhibition by its sub-licensees of films and programmes abroad. That the Board of Review made this assumption appears also from the reference in their first determination to the profits accruing to TVBI from the fees derived from the sub-licencing being sourced in the countries to which the sub-licences related. This reference once again appears to equate the origin of the fees paid by the sub-licensees with the profits accruing to TVBI from the grant of the sub-licensing. If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment which he receives is no doubt sourced in Manila but his profit on the transaction arises in and is derived from his manufacturing operation in Hong Kong.

Although Godfrey J. correctly concluded that the operation of TVBI which generated the taxable profits was one carried on in Hong Kong he went too far in saying that a taxpayer must establish the existence of a profit-generating operation outside Hong Kong if he is to escape a charge to tax under section 14. It is clear from the *Hang Seng Bank* case that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch. The Court of Appeal were in error in stating that "the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong". The profit making activity of the sub-licensees was carried on outside Hong Kong but the grant of the sub-licences took place in Hong Kong where TVBI operated. Furthermore the courts' alternative conclusion that the profit arose in or derived from the places where these assets were licensed erroneously presupposes that the rights in question had a fixed *situs* outside Hong Kong whence profits accrued not to the sub-licensees but to TVBI. In their Lordships' view the Court of Appeal failed to give proper consideration to the fundamental question of what were the operations of TVBI which produced the relevant profit.

It only remains to consider Mr. Park's final submission that the Board of Review's determination that the profits accruing to TVBI were sourced in the countries in which the sub-licensees were entitled to exercise the rights conferred by the sub-licences was an inference of fact which, given the concurring judgment of the Court of Appeal, could only be criticised on *Edwards v. Bairstow* principles. The short answer to this submission is that at the outset the Board of Review, in stating the issue for their decision, addressed themselves to the wrong question and in their consideration of the facts failed to apply the principles of law stated by Atkin L.J. in *Smidth & Co. v. Greenwood* and Lord Bridge in the *Hang Seng Bank* case.

Their Lordships will humbly advise Her Majesty that the appeal should be allowed and the order of Godfrey J. of 9th April 1990 restored. TVBI must pay the Commissioner's costs before this Board and in the Court of Appeal.