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The Commercial Unit, Civil Division
The Department of Justice

What's inside

Editorial

We feature three articles in this edition.

The first article talks about the difference between liquidated damages and unliquidated damages and the circumstances where a claim for unliquidated damages is allowed even with a liquidated damages clause in place.

The second article provides an overview of the proposal under the Companies (Amendment) Bill 2024 to promote paperless corporate communication for Hong Kong companies. The proposal is formulated to enhance the cost-effectiveness and operational efficiency of companies and to promote a green business environment in Hong Kong.

The third article outlines the main features of the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance which introduces a preferential tax treatment for profits derived from eligible intellectual property.

We also feature three case reports in this edition.

In the first case, the CFI discussed the legal principles of the duty of confidentiality and duty of good faith in the context of a franchise agreement and awarded exemplary damages against the franchisee as punishment for his reprehensible conduct and lack of good faith in intending and actually causing loss to the franchisor.

In the second case, the plantiff purchased a beauty package from a service provider and the purchase was financed by a bank, under which the bank advanced the full cost to the service provider and the plantiff agreed to repay the bank the full cost plus interest by instalments. The CFI held that even in the case of breach or non-performance by the service provider under the underlying service agreement, the plantiff was still bound to fulfil her repayment obligations to the bank under the finance agreement.

In the third case, the taxpayer in Hong Kong appointed a Japanese company to introduce to the taxpayer sub-licensees in Japan for its trademarks. Under the agreement, the taxpayer would receive an upfront payment from the Japanese company upon appointment and 40% of the royalties to be received from the sub-licensees in Japan. One of the questions before the CFA was whether the upfront payment was capital or revenue in nature.

YUNG Lap-yan

Introduction

A breach of contract entitles a claimant to sue for damages. In general, the purpose of damages is to compensate the claimant for losses sustained arising out of the breach. Damages can either be liquidated or unliquidated.

Liquidated Damages

It is not uncommon for contracting parties to include a liquidated damages clause ("LD Clause") in a contract which provides for a pre-agreed amount of money for particular types of breach. The inclusion of an LD Clause avoids difficulties of proving actual loss, facilitates recovery of damages and provides greater certainty for the parties. Such pre-agreed damages are known as "liquidated damages".

Unliquidated Damages

Where there is no LD Clause in the contract, a claimant may resort to seeking unliquidated damages from the contract-breaker.

"Unliquidated damages" refer to the amount payable by a contract-breaker for its breach of contract, the exact amount of which is not pre-agreed but is determined by the court after the breach occurs and upon the claimant's proof of its entitlement to damages.

LD Clause

As a general principle, if an LD Clause is valid and operable, a claimant cannot sue for unliquidated damages, even if the liquidated damages do not reflect the actual loss suffered by the claimant. In *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd*[1], the contract required the claimants to deliver and erect a chemical plant in 18 working weeks from receipt of final approval of the drawings, or else the claimants had to pay to the defendants a sum of 20*l*. for every week that they were in default. The claimants were 30 weeks late in completing the work. The claimants sued the defendants for the contract price, and the defendants counterclaimed 5850*l*. as the actual loss suffered because of the delay in completion. The House of Lords held that the weekly sum of 20*l*. was liquidated damages agreed by the parties and hence the claimants were liable for 600*l*. and no more.

However, there may be circumstances where a claim for unliquidated damages is allowed even with an LD Clause in place.

The LD Clause is Void

Where an LD Clause is void, a claimant cannot recover any liquidated damages but is not precluded from pursuing its claim for unliquidated damages by proving the damages suffered from the contract-breaker's breach.[2]

In the past, an LD Clause would be void as penalty if the sum stipulated for was extravagant and unconscionable and it could not conceivably be proved to be a genuine pre-estimate of damage,[3] which is known as the penalty rule.

The Supreme Court in *Cavendish Square Holding BV v Makdessi; Parking Eye Ltd v Beavis*[4] reformulated the penalty rule and laid down the modern test of validity of an LD Clause. Following *Cavendish*, the fact that an LD Clause does not reflect a genuine pre-estimate of loss will not automatically render it penal and void. Instead, the contract-breaker should first identify the legitimate interest of the claimant protected by the LD Clause and prove that the liquidated damages are out of all proportion to the legitimate interest.[5] In this regard, the Supreme Court remarked that, in a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption has to be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.[6]

It is believed that LD Clauses will less likely be set aside by court as unenforceable in post-*Cavendish* era.

The Breach is Outside the Scope of the LD Clause

Where an LD Clause only covers certain specific types of breach, a claimant can sue for unliquidated damages in the ordinary way for other types of breach which fall outside the scope of the LD Clause.[7]

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1 [1933] AC 20

2 *The Rapid Building Group Limited v Ealing Family Housing Association Limited* (1984) 1 Con LR 1

3 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79

4 [2015] UKSC 67

5 *ibid.*, at [32]

6 [2015] UKSC 67, at [35]

7 *Peak Construction (Liverpool) Ltd v Mckinney*

In *Aktieselskabet Reidar v Arcos Ltd*[8], where the LD Clause only covered loss incurred by the detention of the vessel, the court granted the claimant unliquidated damages on top of liquidated damages for the loss of freight due to the inability to load a full cargo after the detention.

Considerations for Inclusion of LD Clause in Contract

As discussed above, even if an LD Clause is in place, liquidated damages may not be awarded in case the LD Clause is void or the breach is outside the scope anticipated by the LD Clause. Hence, LD Clauses are typically included in contracts where the potential damage from a breach can be reasonably estimated at the time of contract formation. This is often the case in supply contracts or other agreements where the losses resulting from a breach such as delay or non-performance can be anticipated and quantified in advance.

For an LD Clause to be enforceable, it should clearly identify the circumstances under which liquidated damages will be applied and ensure that the liquidated damages represent a reasonable estimate of the potential loss from a breach.

Silvia Tang

Foundations Ltd (1970) 1 BLR 111

8 [1927] 1 KB 352

Promoting Paperless Corporate Communication for Hong Kong Companies

Background

Since 2010, provisions have been included in the predecessor Companies Ordinance to facilitate electronic communication by companies with their shareholders and debenture holders.

Commencing on 31 December 2023, the Hong Kong Exchanges and Clearing Limited ("HKEX") has implemented the revised Listing Rules, which allow a listed company, if permitted by the laws of its place of incorporation and its constitutional documents, to adopt the implied consent mechanism for electronic dissemination of corporate communication, including by means of a website.

In view of the latest development concerning listed companies, the Financial Services and the Treasury Bureau ("FSTB") conducted a public consultation on the proposal to promote paperless corporate communication for Hong Kong companies ("Proposal"). The public consultation received majority support from the community.

The Companies (Amendment) Bill 2024 ("Amendment Bill") for implementing the Proposal was published in the Gazette on 22 November 2024 and was introduced into the Legislative Council on 4 December 2024.

Existing regime

At present, Part 18 of the Companies Ordinance (Cap. 622) ("CO") sets out the provisions on electronic communication by a company to other persons.

A company may communicate with their shareholders or debenture holders by electronic means if the company has obtained their prior express consent, either generally or specifically[9]. Communication by electronic means, e.g. by email, means that the company may, with the consent of the individual shareholder or debenture holder, send them the relevant documents or information by email instead of by post.

A company may also communicate with its shareholders or debenture holders by means of a website if the company has the latter's prior express or deemed consent. Communication via a company's website is generally used when the company disseminates mass notification to all shareholders or debenture holders. Under the deemed consent mechanism in s.833 of CO, a company may individually request its shareholders or debenture holders to agree that documents or information may be sent to them by making it available on a website. The request should clearly state that the shareholder or debenture holder is deemed to have consented to receiving communication via website if the company has not received a response within 28 days of the company's request. The company should notify its shareholders or debenture holders every time when any document or information is made available by the company on a website.

Where shareholders or debenture holders receive the document or information by electronic communication (e.g. by email/ via website), they may

9 S.831 of CO.

request the same to be provided in hard copy form by the company free of charge[10].

Proposal

The Amendment Bill proposes to amend and to add provisions under Part 18 of the CO so as to implement the Proposal. Below are the major features:

Implied consent mechanism

Under the proposed implied consent mechanism, if the articles of association of a company or the instrument creating the debenture contain(s) a provision to the effect that the company may disseminate corporate communication via website, the company may do so without having to seek prior consent from each of its shareholders or debenture holders. Both listed and unlisted companies incorporated in Hong Kong may choose to adopt the implied consent mechanism.

Separate notification requirement

Under the Proposal, a listed company will no longer be required to send separate notifications to its shareholders or debenture holders whenever it uploads a corporate communication to its website. This is because shareholders or debenture holders of a listed company are already able to receive notifications of listed companies' information by email or mobile alerts via the News Alert service on the HKEX's website.

Also, an unlisted company will not be required to send separate notifications to its shareholders or debenture holders if they have given one-off prior express consent not to receive such notifications.

Safeguards

FSTB has proposed to put in place the following safeguards in CO to protect the interests of shareholders and debenture holders:

(a) both listed and unlisted companies intending to adopt the implied consent mechanism will be required to first send a one-off notification to each of their shareholders and debenture holders, informing them of the arrangements for electronic dissemination of corporate communication via website.

(b) for any document or information made available on a website by the company, its shareholders and debenture holders will be entitled to request the company to send the same to them in electronic form free of charge. This is in addition to the existing right of the shareholders and debenture holders to request for free hard copy under the current CO[11].

(c) while all shareholders or debenture holders of a company adopting the implied consent mechanism will be considered to have impliedly consented to receiving corporate communication of the company via website, they may revoke their implied consent any time.

Revision of articles

Companies may wish to review whether their articles contain any provision that prohibits them from communicating electronically and to consider whether to make any revision to their articles as appropriate.

Concluding remarks

The Government is committed to providing a business friendly environment for companies to operate in Hong Kong and enhancing Hong Kong's status as an international business and financial centre. The Proposal is formulated to help enhance the cost-effectiveness and operational efficiency of companies, thereby achieving the objectives of streamlining procedures for corporate communication and promoting a green business environment in Hong Kong.

If the Amendment Bill is passed, Hong Kong companies will be given three months beginning on the date of gazettal of the Amendment Ordinance to make any necessary preparation for implementing the Proposal.

Ida Chan

10 S.837 of CO.

11 S.837 of CO.

Introduction

With a view to encouraging more research and development ("R&D") activities, as well as transformation and commercialization of patented inventions, the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance 2024 ("Amendment Ordinance") was enacted in July 2024 to implement a "patent box" regime in Hong Kong.

The "patent box" tax incentive is offered in Mainland China and many overseas jurisdictions. Under the "patent box" regime introduced by the Amendment Ordinance ("Regime"), qualifying profits derived from eligible intellectual property ("IP") will be subject to a concessionary tax rate of 5%, which is substantially lower than the existing normal profits tax rate of 16.5% in Hong Kong.

The Amendment Ordinance was effective from 5 July 2024. The Regime applies in respect of a year of assessment beginning on or after 1 April 2023. This article outlines the major features of the Amendment Ordinance.

Nexus approach

As a member of the Inclusive Framework on Base Erosion and Profit Shifting, Hong Kong is obliged to apply the nexus approach adopted by the Organization for Economic Co-operation and Development ("OECD"). Under the OECD's nexus approach, a taxpayer can only benefit from an IP regime[12] to the extent that it can show that it has incurred qualifying expenditures, such as R&D expenditures, which have given rise to the IP income, and the IP income is from a qualifying IP asset ("eligible IP").[13] The nexus approach seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income.

[12] Many jurisdictions have implemented IP regimes, which allow income from the exploitation of certain IP assets to be taxed at a lower rate than the standard statutory tax rate. IP regimes may be used by governments to support R&D activities in their jurisdictions.

[13] https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/harmful-tax-practices/explanatory-paper-beps-action-5-agreement-on-modified-nexus-approach-for-ip-regimes.pdf

"Eligible IP"

Under the Regime, eligible IP that could qualify for preferential tax treatment are limited to patents, plant variety rights and copyrighted software.

With a view to enhancing the competitiveness of the Regime, a liberal approach is adopted by the HKSAR Government in two-fold:-

First, in addition to patents and plant variety rights that have been granted, the **applications** for patents and plant variety rights will also be taken into account as falling within the scope of "eligible IP" under the Regime. Nonetheless, if the applications for patents and plant variety rights concerned do not eventually result in a grant, the portion of assessable profits for which tax concessions are claimed will be subject to the standard profits tax rate accordingly.

Second, in addition to patents and plant variety rights granted in Hong Kong, patents and plant variety rights **granted outside Hong Kong** will also be taken into account as falling within the scope of "eligible IP", subject to certain additional requirements set out in the new Schedule 17FD to the Inland Revenue Ordinance (Cap.112) introduced by the Amendment Ordinance ("Schedule 17FD").

How to ascertain assessable profits covered by the Regime?

The detailed mechanism for ascertaining the qualifying profits derived from eligible IP is set out in Schedule 17FD. Some key concepts are highlighted below.

"Eligible IP Income"

Taking a liberal approach, the "patent box" tax incentive covers a wide scope of income derived from eligible IP, including:-

(a) income derived from an eligible IP in respect of the exhibition or use of (whether in or outside Hong Kong) the IP; or the imparting of knowledge connected with the use (whether in or outside Hong Kong) of the IP;

(b) income arising from the sale of an eligible IP;

(c) embedded IP income, i.e. the portion of the price of a product or service that is attributable to the value of an eligible IP; and

(d) insurance, damages or compensation derived in relation to an eligible IP.

"Eligible R&D Expenditure"

In accordance with the OECD's nexus approach, only eligible R&D expenditures that have been incurred by taxpayers to develop the eligible IP will be taken into consideration to determine the portion of assessable profits that could benefit from the preferential tax treatment under the Regime. Acquisition costs of the IP are not considered as eligible expenditures.

Eligible R&D expenditures cover the expenditures on R&D activities that are undertaken by the taxpayer (or any outsourced third parties) inside or outside Hong Kong.

Treatment of Losses and Related Offsets

Under the Amendment Ordinance, a mechanism is provided for cross set-off of losses incurred in relation to income benefiting from the concessionary tax rate under the Regime against assessable profits subject to a different tax rate, so long as the amount of losses for cross set-off is to be adjusted with reference to the tax rate difference.

For illustration, if a taxpayer incurs a loss from activities eligible for the Regime (i.e. subject to a concessionary tax rate of 5%) and on the other hand has other assessable profits from activities not eligible for the Regime (i.e. subject to the standard tax rate of 16.5%), the said loss can be set off against the assessable profits that are subject to the standard tax rate of 16.5%, on the condition that the amount of loss is adjusted according to the tax rate difference.

Record Keeping Requirements

One of the essential requirements of the nexus approach is the tracking and tracing of R&D expenditures and income derived from the eligible IP. Hence, the Amendment Ordinance imposes record keeping requirements on the taxpayers concerned, for example, keeping record of information sufficient to establish that the income concerned is eligible IP income and details of the eligible IP to which the income relates.

Other Useful Information

The Inland Revenue Department has provided useful information in relation to the Regime on its website for taxpayers' reference.[14]

Connie Yip

Mammy Pancake Co Ltd v Carla Day Ltd [2024] 3 HKLRD 17

Facts

The plaintiff ("P") owned the franchise for selling egg waffles under the brand name "Mammy Pancake". In 2015, a franchise agreement was entered into by the 1st defendant ("D1"), the 2nd defendant ("D2") as a guarantor, and P for granting P's franchise to D1. P found a shop (the "Shop") suitable for operation of the franchise and told D2 about it. P also told D2 that the information about the Shop's lease would remain confidential even if D1 did not take up the franchise, as P would look for another franchisee. A lease of the Shop was later entered into between D1 and the landlord.

Shortly afterwards, the Shop was granted a Michelin Award (the "Award") for 6 years until 2021. The Award was related specifically to the Shop, i.e. if the Shop were no longer operated, the "Mammy Pancake" brand would lose the Award. The Shop was obviously of strategic importance to P's franchise as a whole.

In 2018, the parties entered into another franchise agreement (the "Franchise Agreement") to extend D1's franchise at the Shop to April 2021. The Franchise Agreement expressly imposed a duty of confidentiality and a duty of good faith on the parties, but did not specifically require non-disclosure of the information about the Shop's lease.

In 2020, D2 indicated to P that D1 might not renew the Franchise Agreement. P informed D1 and D2 that if they did not want the franchise to continue, P would itself operate the Shop in order to keep the Award for the brand. P proceeded to negotiate a reduced rent of the Shop with the landlord, and informed D1 and D2. D2 then led P to believe that D1 would renew the Franchise Agreement and the lease of the Shop. D2 also misrepresented to the landlord that the 5th Defendant ("D5"), being D1's employee, was P's representative. In the end, D5 obtained the lease of the Shop at the reduced rent. P sued D1 and D2, among others, for (i) breach of duties of confidentiality and good faith under the Franchise Agreement; and (ii) damages for the breaches.

[14] https://www.ird.gov.hk/eng/tax/bus_patentbox.htm

Legal Principles

The Court discussed the legal principles of the duty of confidentiality and duty of good faith.

Duty of confidentiality

A duty of confidentiality arises when confidential information comes to the knowledge of a person, in circumstances where he has notice, or is held to have agreed, that the information is confidential, with the effect that it would be just in all the circumstances that he should be precluded from disclosing the information to others.[15]

There are three requirements for establishing a breach of duty of confidentiality: (i) the information in respect of which relief is sought must have the "necessary quality of confidence about it"; (ii) the information must have been imparted in circumstances importing an obligation of confidence; and (iii) there must be an unauthorised use or disclosure of that information.[16]

Duty of good faith

Following the general approach to construction, the scope and meaning of a duty of good faith depend on the intention of the parties as construed objectively from the wording used by the contract, the context of the contract as a whole (including its overall purpose where relevant), and the matrix of fact in which it was concluded.[17] The "core meaning" of a duty of good faith is to act honestly: *Re Compound Photonics Group Ltd, Faulkner v Vollin Holdings Ltd*.[18]

A good faith clause in a contract typically includes the obligations: (i) to act honestly and with a fidelity to the bargain; (ii) not to act dishonestly and not to undermine the bargain entered or the substance of the contractual benefit bargained for; and (iii) to act reasonably and with fair dealing having regard to the interests of the parties and to the provisions, aims and purposes of the contract: *Goldbay Fortis Ltd v Rich Resource Development Ltd*[19] and *Knights Quest Pty Ltd & Anor v Daiwa Can Company & Anor*.[20]

Decision

Breach of duties of confidentiality and good faith

In this case, the Court said that, although the non-disclosure of information about the Shop's lease was not expressly stated in the Franchise Agreement, the scope of the duties of confidentiality and good faith can be ascertained in the factual matrix and all the circumstances of the case. It was apt to look at both the confidentiality and good faith clauses together in this case.

The Court considered that P, D1 and D2 were in a special relationship of franchisor and franchisee with the common goal of furthering the franchise's interest. The Shop had the Award and P had specifically informed D2 that P would take up the lease in case D1 were not to renew it. Hence, the duty of confidentiality in the context of the duty of good faith must cover the information about the Shop's lease. The Court also believed that D2 had lied to P and misrepresented to the landlord so that D5 could obtain the lease. The Court therefore found that D1 and D2 had been acting dishonestly in breach of the duties of confidentiality and good faith under the Franchise Agreement.

Losses and damages

The Court awarded damages for loss of profits to P, having considered that if D2 acted in good faith and did not arrange D5 to obtain the lease, P could have taken up the lease itself and earned profit by continuing running the Shop.

P alleged that, since Mammy Pancake no longer held the Award, P had lost 33 potential franchisees. P claimed damages for the loss of the related franchise fees. The Court did not grant the damages as there was no evidence of a direct link between the loss of the 33 potential franchisees and the loss of the Award.

However, the Court found that exemplary damages, instead of the damages for loss of potential franchisees, should be awarded to P. In law, exemplary damages could be awarded for equitable wrongs including the breach of duty of confidentiality. The rationale for exemplary damages is not to compensate but to punish: *William Allan v Ng & Co (a firm)*.[21] In the present case, the Court ruled that, exemplary damages were awarded, not as an adjunct or alternative to the damages for loss of profits, or loss of goodwill of the Award, but as punishment of D1 and D2's reprehensible conduct and lack of good faith in intending and actually causing loss to P.

Daisy Law

[15] Clerk & Lindsell on Tort, 24th Ed., para. 25-01.
[16] Clerk & Lindsell on Tort, 24th Ed., para. 25-06.
[17] Chitty on Contracts, 35th Ed., para. 2-060.
[18] [2022] EWCA Civ 1371 per Snowden LJ at [241].
[19] [2021] HKCFI 1684.
[20] [2019] 366 ALR 557 at [83] and [84].
[21] [2012] 2 HKLRD 160.

黃偉成 v 交通銀行股份有限公司 [2024] HKCFI 1902

Facts

The wife of the Plaintiff ("P") purchased a beauty package from a service provider ("Provider") under a service agreement ("Agreement"). The purchase was financed by an instalment payment plan ("IPP") offered by the defendant bank ("D"), under which D advanced the full cost to the Provider and P's wife agreed to repay D by instalments with her supplementary credit card.

P, the principal credit cardholder and hence liable for the debts incurred on his wife's supplementary credit card (including the debts under the IPP), gave notice of rescission of the Agreement to the Provider on behalf of his wife. P further requested D to cancel the IPP and the payment to the Provider. D refused and charged P the principal amount under the IPP, together with additional bank charges, including late payment interest ("Charges").

In the proceedings by P's wife at the Small Claims Tribunal ("SCT") against the Provider, SCT ruled that the Agreement was vitiated by the Provider's fraudulent misrepresentation. SCT awarded to P's wife the full price of the Agreement but not the Charges. P thus claimed against D to recover the Charges, arguing that the IPP was invalid because the Agreement had been rescinded.

SCT dismissed P's claims and held that the Provider's fraudulent misrepresentation that vitiated the Agreement could not be relied upon to rescind the IPP. P appealed to the Court of First Instance ("Court").

P's argument

Citing *Durkin v DSG Retail Ltd*[22] ("*Durkin*"), P argued that since the IPP was entered into for the sole purpose of financing the Agreement, it would include an implied term in law that it was conditional upon the survival of the Agreement ("Implied Term"). Once the Agreement was terminated, the IPP would serve no purpose, and P claimed that he could rescind the IPP.

Alternatively, if the Implied Term could not be implied in law, P claimed that the STC had erred in failing to imply the Implied Term on the facts of the case.

Decision

The Court noted that a term may be implied in law based on considerations such as reasonableness, fairness and balancing of competing policy objectives, unless the parties had expressly excluded such implied term: *Geys v Societe Generale, London Branch*[23].

Durkin in gist held that it was an implied term of a credit agreement that such agreement was conditional upon the survival of the supply agreement. In deciding whether *Durkin* should be applied in Hong Kong, the Court considered that local legal and societal circumstances should be taken into account.

The Court found that the reasoning in *Durkin* for implying a term in a credit agreement was rooted in the characteristics of debtor-creditor-supplier agreements as regulated under the UK Consumer Credit Act 1974 ("UK Act"). For a debtor-creditor-supplier agreement regulated by the UK Act, if a supply contract was brought to an end by the debtor's acceptance of the supplier's repudiatory breach, when the debtor recovered damages from the supplier, the debtor must repay to the creditor what the creditor had paid to the supplier. The reality was that the credit agreement between the debtor and the creditor would come to an end upon the rescission of the supply contract. It was for reflecting such reality that in *Durkin*, a term was implied in law to render the credit agreement conditional on the survival of the supply contract.

The position of Hong Kong was different. There was no legislation equivalent to the UK Act. The Court further observed that financial institutions in Hong Kong operated differently, in that they could formulate their own terms and conditions for instalment payment plans, including express provisions that whether or not the services were provided by the supplier, the payment obligation continued. In other words, financial institutions in Hong Kong were free to enter into instalment payment plans with customers which provided for the survival of the credit agreement, even in case of breach or non-performance of the underlying service contract.

The terms of the IPP precisely demonstrated the independent survival of the IPP even after the Agreement had been rescinded. The IPP was structured in a way that the full price of the beauty package was paid by D to the Provider once the IPP was approved by D. P's wife therefore owed no further payment obligation to the Provider as such obligation had been fulfilled. Instead, P (as the

[22] [2014] 1 WLR 1148

[23] [2013] 1 AC 523

principal card holder) would remain obliged to pay D in accordance with the IPP. Implying the Implied Term in the IPP that it was conditional upon the survival of the Agreement would be contrary to the above reality as reflected in the terms of the IPP.

Given the above difference between the position in the UK and in Hong Kong and how the IPP was designed, the Court concluded that it would be inappropriate to apply the reasoning in *Durkin* to imply the Implied Term in the IPP in law.

The Court further considered P's alternative argument whether the Implied Term could be implied on the facts of the case. The authorities stated that no term could be implied into a contract if it contradicted or was inconsistent with an express term in the contract. Such contradiction or inconsistency could take the form of linguistic inconsistency (i.e. the wording of a proposed implied term contradicted, as a matter of language or grammar, with an express term) or substantive inconsistency (i.e. a proposed implied term did not fit with the substance of the parties' rights and obligations under the express terms).

In the present case, the terms of the IPP clearly provided that (i) P's wife would not be able to stop the monthly instalment payment to D even if the Provider did not deliver the services; (ii) P's wife's repayment obligation to D under the IPP would not be affected by any claims made by her against the Provider; and (iii) P's wife would not be able to rely on a claim against the Provider to avoid fulfilling her repayment obligation to D. The Implied Term would be both linguistically and substantively contrary to the above express terms of the IPP. Accordingly, the Court rejected P's alternative argument that the Implied Term ought to have been implied on the facts of the case and dismissed P's appeal.

Isabella Wong

Patrick Cox Asia Limited v The Commissioner of Inland Revenue [2024] HKCU 4254

Facts

Patrick Cox Asia Limited ("Taxpayer") is a Hong Kong incorporated company. Its parent company owned certain marks, logos and devices (collectively "Trademarks"), and granted the Taxpayer a master licence to use the Trademarks ("Master Licence"), including the right for the Taxpayer to grant sub-licences to any third party in the Asia Pacific Region.

The Taxpayer entered into a deed ("Deed") with a Japanese company ("Japan Co") under which Japan Co shall introduce to the Taxpayer sub-licensees who are interested in marketing, promoting and distributing the Taxpayer's products in Japan ("Licensing Business"). The Deed further provides that any royalty income received by the Taxpayer through sub-licensing ("Royalties") shall be shared between the Taxpayer and Japan Co on a 40:60 basis.

Upon signing of the Deed, Japan Co paid the Taxpayer an upfront payment ("Upfront Payment") as an initial fee for obtaining the right to participate in the Licensing Business and sharing of profits therefrom.

Between April and June 2009, Japan Co procured the entering into of three sub-licensing agreements ("Sub-licence Agreements") between the Taxpayer and Japanese sub-licensees ("Sub-licensees").

Between 2009 and 2013, the Taxpayer received the Royalties from the Sub-licensees, 40% of which was retained by the Taxpayer as its income ("40% Royalties"), with the remaining 60% going to Japan Co, pursuant to the Deed.

The Commissioner of Inland Revenue ("CIR") determined that the Upfront Payment and 40% Royalties were both taxable revenue items sourced in Hong Kong for the assessment years 2009/10 to 2012/13.

The Taxpayer disagreed and appealed to the Board of Review ("Board"). The Board ruled in favour of CIR. Dissatisfied, the Taxpayer appealed to the Court of First Instance ("CFI"). CFI upheld the Board's decision. The Taxpayer appealed to the Court of Appeal ("CA").

Issues

S. 14(1) of the Inland Revenue Ordinance (Cap. 112) ("IRO") provides:

> "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment 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."

According to s. 2(1) of IRO, "profits arising in or derived from Hong Kong", unless the context otherwise requires, "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".

The issues before CA were (1) whether the Upfront Payment and the 40% Royalties were "profits arising in or derived from Hong Kong" under s. 14(1) of IRO; and (2) whether the Upfront Payment was capital or revenue in nature.

<u>CA's decision</u>

<u>Source of the Upfront Payment</u>

CA held that the Taxpayer received the Upfront Payment from Japan Co under the Deed, rather than from an exercise of any rights in the Trademarks either by the Taxpayer or Japan Co. The Upfront Payment was in substance a payment made by Japan Co for being appointed by the Taxpayer as its agent managing the Licensing Business and obtaining the right to receive 60% share of the Royalties. Such appointment was done with the authority emanating from Hong Kong, pursuant to a contract negotiated on the Taxpayer's behalf from and signed by the Taxpayer in Hong Kong, and in accordance with Hong Kong law. Japan Co's share of the Royalties was promised by the Taxpayer from Hong Kong and to be paid by the Taxpayer under the Deed.

Accordingly, CA upheld the Board's decision that the Upfront Payment arose in or derived from Hong Kong and hence taxable.

<u>Source of the 40% Royalties</u>

CA held that the Board erred in law in determining Hong Kong as the geographical source of the 40% Royalties by:

(i) taking into account the irrelevant fact that the Deed was negotiated from and signed in Hong Kong on the Taxpayer's behalf; and

(ii) failing to consider the following relevant matters: (1) Japan Co's activities in marketing the Trademarks, securing the Sub-licensees and procuring the Sub-licence Agreements; (2) Japan Co's activities in servicing the Sub-licence Agreements after the execution of the Sub-licence Agreements; and (3) the fact that the Royalties were payable not on the grant of the sub-licences but only on the exercise of the licensed rights in Japan as a percentage of the Sub-licensees' sales.

Nevertheless, having considered that the Taxpayer acquired the Master Licence in Hong Kong, CA did not find that the 40% Royalties must in its entirety be regarded as having a source outside Hong Kong, and indicated that part of the 40% Royalties may on an apportionment basis be held taxable. CA remitted this issue to the Board for factual determination.

<u>Whether the Upfront Payment is a capital receipt</u>

CA agreed with the Board that the Upfront Payment was revenue in nature and hence subject to profits tax assessment based on the following grounds:

(i) the cooperation arrangement between the Taxpayer and Japan Co was only 3.5 years under the Deed, subject to a conditional option of renewal. Such arrangement cannot be regarded as a permanent structure of the Taxpayer's profit-making operations or as giving Japan Co an enduring interest in the Trademarks;

(ii) the Taxpayer received the Upfront Payment for exploiting its rights in the Trademarks through cooperating with Japan Co, but not for disposing of its capital asset or transferring its business to Japan Co;

(iii) while the Upfront Payment served to protect the Taxpayer from the risk of Japan Co defaulting, this element of risk allocation is not determinative of the nature of the Upfront Payment; and

(iv) the Taxpayer's claim that the Deed caused a temporary diminution in the value of its interest in the Master Licence is a mere assertion without evidential basis.

Oswald Law