



## **Source of commission income - Court of First Instance affirms the application of ING Baring**

In *Li & Fung (Trading) Limited* (HCIA 1/2010 and 3/2010), the Court of First Instance upheld the Board of Review's decision, finding in favour of the taxpayer that the source of the commission income was outside of Hong Kong. The Court declined to follow the Commissioner of Inland Revenue's argument that the income of the taxpayer should be apportioned on the basis that the management and supervision of overseas affiliates, which were undertaken in Hong Kong, were key factors in producing the taxpayer's profits.

### **Background**

The taxpayer, a member of the Li & Fung group, provides services to its customers in connection with the manufacture, sale and purchase of goods. These services included finding suppliers for goods to be manufactured and the sale of such goods by the suppliers direct to the taxpayer's customers. The taxpayer manages the sourcing and manufacturing processes for its customers to ensure that the goods supplied to its customers satisfied quality control standards. Many of the taxpayer's services were provided outside Hong Kong, through local offices. In most cases, the local offices were affiliates of the taxpayer and were engaged by the taxpayer to perform the services the taxpayer had contracted to provide to its customers. Upon delivery of the finished goods to its customers, the taxpayer was usually paid a commission of six percent of the total FOB value of the customer's export sales. The taxpayer paid the affiliates a percentage (say four percent) of the FOB value of the customer's export sales for their services.

### **The decision of the Board of Review**

The Board held that the taxpayer was "a commission agent" and that in short, "sold services for commission". The Board further found that the affiliates were agents of the taxpayer. The Board rejected the Commissioner's suggestion that the affiliates were sub-contractors, which the taxpayer had employed to perform services that it had agreed to perform for its customers. The Board noted that the taxpayer employed the local affiliates in carrying out transactions for its customers. It followed from this that the taxpayer's profits were earned in the place where the affiliates carried out the taxpayer's instructions, whether they did so as agents or principal.

## The issue

Were the taxpayer's profits relating to goods sourced from suppliers located in places other than Hong Kong offshore and hence not chargeable to Profits Tax?

## The Commissioner's argument

The Commissioner argued before the Board that the taxpayer's profits were the difference between the six percent, which it received from its customers and the four percent, which it paid to its affiliates and that such commissions related to services rendered in Hong Kong. However, before the Court, the Commissioner argued that the commission should be apportioned on the basis that activities were carried out both in Hong Kong and overseas. The Commissioner, therefore, effectively acknowledged that some of the commission income related to offshore activities. However, he argued the management and supervision of the overseas affiliates by the taxpayer in Hong Kong were also key factors in producing the taxpayer's profits.

## The decision

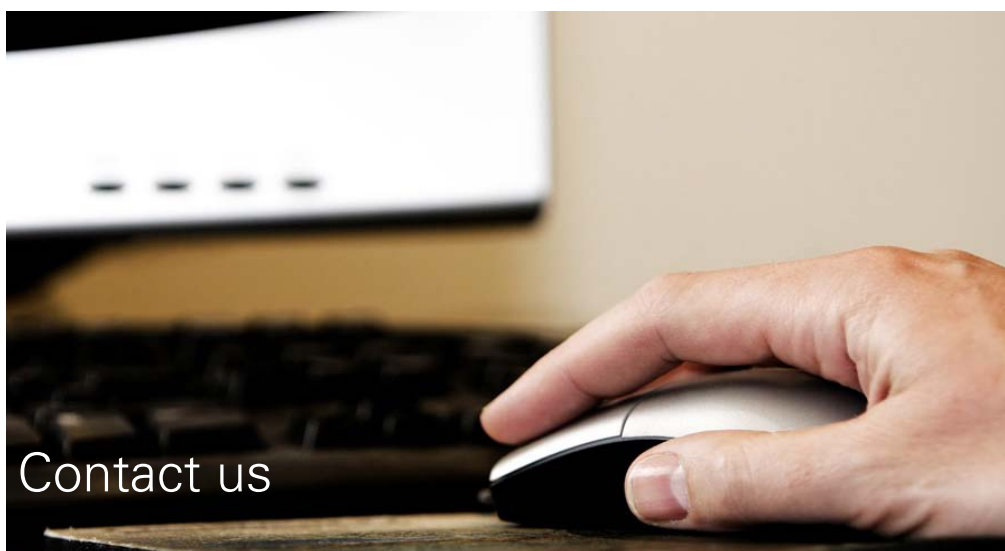
The Court noted that the Board did precisely what the Court of Final Appeal says the Board had to do. That is, as required by *ING Baring*, the Board had to (and did) identify the activities giving rise to the relevant gross profit.

The Board held that what generated the taxpayer's gross commission of six percent were the sourcing and agency activities, which were carried out through overseas affiliates. The affiliate companies (acting on behalf of the taxpayer) assisted customers in placing orders with offshore sellers, supervised the manufacturer by those sellers of goods to the specifications of the customers, and arranged for the shipment of the finished goods from the sellers to the customers. It was those activities the Board found which directly led to the payment of a gross commission of six percent. Those activities took place outside Hong Kong.

The Court noted that whilst it was true that the taxpayer maintained back-up or support services for its affiliates at its Hong Kong headquarters, the Board was entitled to disregard the same as merely (in the words of Ribeiro PJ in *ING Baring*) "antecedent activities" which although "commercially essential to the operations and profitability of [the taxpayers business ... do not provide the legal test for ascertaining the geographical source of profits".

## Comment

The Court's decision reaffirms the approach in *ING Baring* that to determine the source of a profit one must first identify the transaction which directly gives rise to the profits. That is, the focus should be on the effective causes to the exclusion of what may be antecedent or incidental matters. As is clear from the arguments advanced for the Commissioner, the IRD has been reluctant to apply the principles stemming from *ING Baring* to cases that were not factually the same as that of *ING Baring*. Indeed, the IRD has taken the position that the final step in the process of profit generation is not always determinative of the source of profits, and that due regard must be given to prior steps. Although the decision in the *Li & Fung* case may be subject to appeal, the case does highlight that the *ING Baring* decision has wider application in determining the source of profits.



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