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Tax alert

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Source of commission income - Court of Appeal reaffirms the application of ING Baring

In *CIR v Li & Fung (Trading) Limited* (CACV 86/2011), the Court of Appeal upheld the decision of the Court of First Instance (see Tax alert Issue 10 – April 2011), which found in favour of the taxpayer that the source of the commission income was outside of Hong Kong. The Court again 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 is a member of the Li & Fung group. The taxpayer's business included services, which it provided to its overseas customers for which, typically, the taxpayer was paid six percent of the FOB value of the goods supplied to them. The taxpayer, in turn, entered into contracts with local companies, typically its affiliates, under which the local companies would provide services to the taxpayer in return for four percent of the FOB value. The assessments related to profits derived for the years of assessment 1992 to 2002.

The Board of Review

The Commissioner argued before the Board of Review that the taxpayer's profits represented the difference between the six percent, which it received from its customers and the four percent, which it paid to its affiliates. The Commissioner suggested that the taxpayer operated a 'supply-chain management business' and the two percent margin it earned from that business in Hong Kong.

The Commissioner's case was rejected by the Board, which held that the taxpayer was 'a commission agent' whose business was undertaking, on behalf of its own customers, the sourcing of merchandise for its customers. In short, the taxpayer 'sold services for commission'.

The Court of First Instance

The Court of First Instance considered the Commissioner's reformulated case where it argued that the Board had erred in not apportioning the gross profit of six percent between sources in and outside of Hong Kong. It was submitted, on behalf of the Commissioner, that the gross profit was earned as a result of activities carried out both in Hong Kong and abroad. Insofar as non-Hong Kong based affiliates were involved, it was accepted that some of the taxpayer's profit had an overseas source. Conversely,, insofar as the taxpayer managed and supervised its affiliates from Hong Kong, part of its profits must have had a Hong Kong source.

The Court of First Instance concluded that the Board's findings and conclusions on the source of the taxpayer's profits were unassailable. There was no basis for saying that the Board ought to have apportioned the six percent commission in the way suggested. It could not be said that the Board acted irrationally or that its conclusions were unsupported by the available evidence.

The Law

The Court of Appeal set out the relevant legal principles as follows. On the question of where the profits were sourced:

"One looks to see what the taxpayer has done to earn the profit in question and where he has done it."- CIR v HK-TVB International Ltd.,

Also, in *Kwong Mile Services Ltd v CIR*: *"… The situations in which the source of a profit has to be ascertained are too many and varied … the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."*

As was made clear in *ING Baring Securities (Hong Kong) Ltd v CIR* one should not:

"… investigate every facet of the Taxpayer's business so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing 'the more important things done' towards the generation of those profits as the criteria for determining geographical source. … (that) places an erroneous emphasis on matters properly regarded as antecedent or incidental to the profit-generating operations."

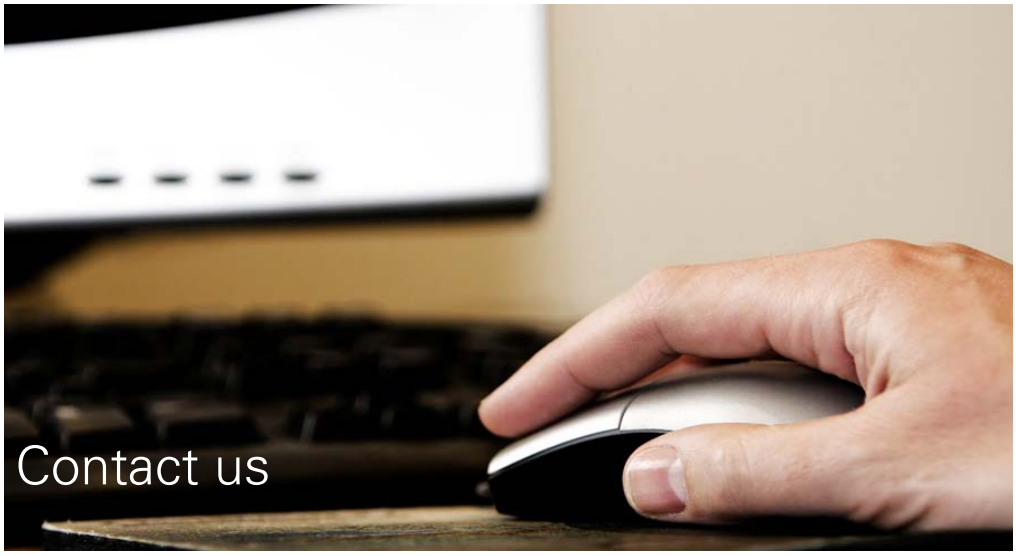
Otherwise, one *"… emphasises antecedent or incidental matters that, while commercially essential, are legally irrelevant. …"*

The decision

The Court of appeal agreed with the decision of the Court of First Instance and noted that its conclusion was amply justified. The Court of Appeal had regard to the submissions made by the taxpayer, which underlined the important distinction between the taxpayer managing its business in Hong Kong and its source of profits by its affiliates outside Hong Kong. The Court held that the taxpayer's case compares well with this description of ING *Baring's* activities in *ING Baring Securities (Hong Kong) Ltd v CIR.*

The decision again 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 profit. Going forward, the Inland Revenue Department (IRD) should now accept that the *ING Baring* decision has a wider application for the source of profits in general and it cannot be restricted to factually similar cases.

Finally, it will also be interesting to see whether the IRD will be granted leave to appeal. As noted in Tax alert Issue 16 – September 2011, *C G Lighting Ltd* was refused leave to appeal as the Leave Committee was not persuaded that there was any question of legal principle to be resolved. Arguably, there is no legal principle to be resolved in the present case, which also does not involve a matter of great general or public importance.



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