Tax
Issue H39/2011 – 5 May 2011

Tax Analysis

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Hong Kong Tax

Court confirms decision in *ING Baring* concerning source principle with regard to commission income

On 18 April 2011, the Court of First Instance (CFI) of the Hong Kong SAR handed down its judgment in *Commissioner of Inland Revenue v Li & Fung (Trading) Limited HCIA 3/2010*. The decision was in favor of Li & Fung (Trading) Limited (LFT) (the taxpayer), and it confirmed the earlier decision of the Board of Review (BoR) that LFT's commission income with respect to goods sourced from foreign suppliers was offshore and, therefore, not chargeable to Hong Kong profits tax.

Hong Kong operates a territorial tax system, according to which only profits that have a source in Hong Kong are assessable to profits tax. The guiding principle in determining source is clear, i.e. what the taxpayer has done to earn the profit in question and where he has done it. In essence, it is necessary to identify the activities that produced the relevant profits and where those activities took place. While the principle seems simple, the application of the source of profits rule in individual cases has been a contentious issue between the Inland Revenue Department (IRD) and taxpayers. The issue arises because among all the operating activities of a business, it is difficult to objectively identify income generating activities and often difficult for the IRD and the taxpayer to reach a consensus without the case ending up in court.

In practice, the determination of the source of profits was evolving from a simple contract test to a "totality of facts" approach before the *ING Baring* case (decided by the Court of Final Appeal (CFA) in 2007). The totality of facts approach was generally criticized as cumbersome and it sometimes led to a result that was inconsistent with the territorial concept of taxation in Hong Kong, which had the potential to weaken Hong Kong's competitive position as an offshore territorial tax regime (see also our Tax Analysis Issue H10/2007 – 31 October 2007).

The CFA's decision in *ING Baring* represented a paradigm shift in the application of the source rule from the totality of facts approach that was normally used by the IRD to determine the source of profits in Hong Kong. The CFA's decision stressed the need to ascertain the geographic location of the taxpayer's income-generating transactions, i.e. the effective causes, rather than other activities antecedent or incidental to those transactions.

The CFI's decision in LFT follows the direction of the source principle that was established in *ING Baring*.

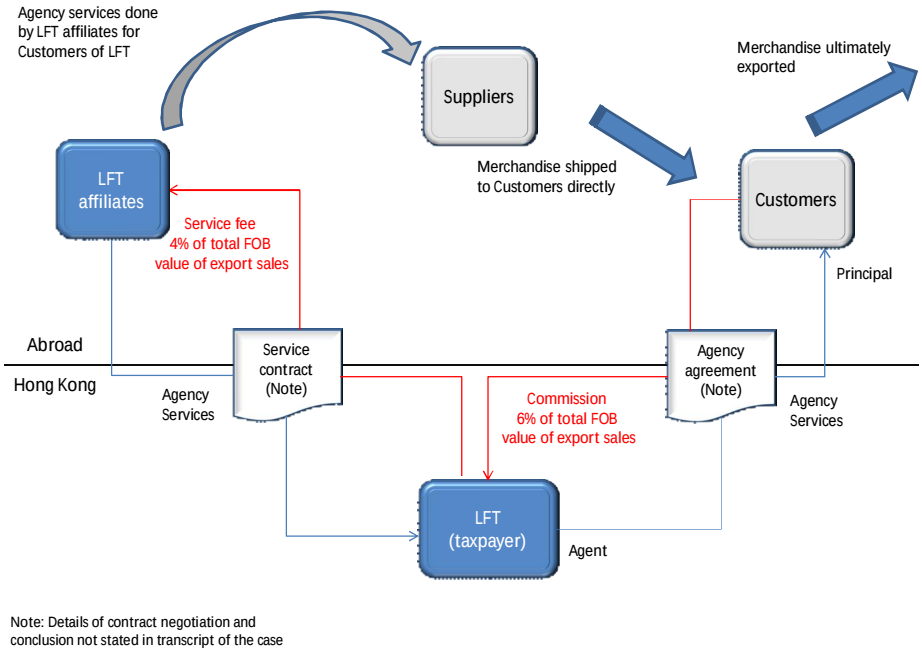
Facts

LFT carries on a business in Hong Kong that provides services to its customers abroad. Under an agency agreement between LFT (Agent) and its customer (Principal), the services to be provided by LFT include, on the Principal's behalf, locating suppliers to carry out manufacturing, placing orders (with prior written authorization from the Principal) with suppliers abroad; maintaining quality control of merchandise produced by suppliers; arranging for the shipment of merchandise; assisting the Principal with settling potential merchandise claims against suppliers; providing the Principal with up-to-date information on new developments in markets where the suppliers are located and signing or countersigning contracts/purchase orders/commitments for the Principal.

LFT also enters into service contracts with its affiliates overseas. Many of LFT's services described above, in practice, are carried out by LFT's overseas affiliates outside Hong Kong.

Upon delivery of merchandise to the customers, LFT is paid a commission that equals 6% of the total FOB value of the customer's ultimate export sales ("6% commission income"). LFT paid its affiliates that carried out the services 4% of the FOB value of the total export sales of the customers ("4% service fee").

The suppliers, customers and LFT were independent parties. The following diagram outlines the key facts of the case:



Note: Details of contract negotiation and conclusion not stated in transcript of the case

Dispute

The IRD assessed profits tax on LFT's commissions earned on orders from overseas customers that were handled by LFT's non-Hong Kong-based affiliates. LFT took the position that the 6% commission income was offshore income and not assessable to profits tax in Hong Kong. LFT objected to the IRD's assessment and appealed to the BoR with regard to the tax liability in dispute.

Arguments of IRD

The IRD argued before the BoR that LFT was actually operating a "supply-chain management business," whereby it received commission income based on 6% of the customer's export sales value and at the same time paid its affiliates overseas the 4% service fee. Further, the Commissioner of Inland Revenue (CIR) suggested that the overseas affiliates were subcontractors employed by LFT. The difference of 2% earned by LFT represented the management of LFT's own activities and those of its affiliates from LFT's headquarters in Hong Kong. The commission income thus has a Hong Kong source and should be taxable.

Decision of the BoR

The BoR disagreed with the CIR, emphasizing that, in determining the source of the commission income, the focus had to be on "establishing the geographic location of LFT's profit-producing transactions themselves as distinct from activities

antecedent or incidental to those transactions."

The BoR held that LFT was "a commission agent," for which it employed the affiliates abroad as agents (as opposed to subcontractors) to act for LFT in carrying out the agency services for the customers. LFT's profits were earned in the place where the LFT's affiliates carried out LFT's instructions overseas. Therefore, the commission income is not sourced in Hong Kong and should not be assessable.

CIR reformulated arguments

The CIR was dissatisfied with the BoR's decision, and the case was brought before the CFI. The IRD changed its argument slightly in the CFI proceedings: instead of pursuing the argument that LFT was carrying out a supply-chain management business in Hong Kong, the IRD argued that the agency services agreed between LFT and its customers could not be performed by the LFT's foreign affiliates on their own. The management and supervision of those affiliates overseas by LFT in Hong Kong were also key factors in producing the commission income. LFT's commission income of 6%, which it received from the customers, was earned as a result of activities carried out both in Hong Kong and abroad and, therefore, should be apportioned. The CIR argued that the apportionment should be to split the 6% commission, with 4% being attributable to the offshore activities of LFT's affiliates and 2% attributable to LFT's activities in Hong Kong.

Decision of the CFI

The judge of the CFI confirmed both the decision and the analysis of the BoR. The judge noted that the BoR correctly followed the *ING Baring* principles as articulated by the CFA, i.e. identify the activities giving rise to the relevant gross profit. The CFI agreed with the BoR that LFT's affiliates overseas, which acted on behalf of LFT assisted LFT's customers in placing orders with suppliers overseas, supervised the production of merchandise made by the suppliers to the specifications of LFT's customers and arranged for the shipment of the merchandise from the suppliers to LFT's customers. In the absence of these sourcing and agency activities which LFT carried out through its affiliates abroad, LFT would not be able to earn the 6% commission income. All of these activities took place outside Hong Kong.

In handing down the CFI's decision, the judge commented that it is true that LFT maintained management and supervisory support services for its overseas affiliates in Hong Kong, but these were "antecedent activities" which, although "commercially essential to the operations and profitability of [LFT's] business …, do not provide the legal test for ascertaining the geographic source of profits," The judge disagreed with the IRD's arguments before the CFI and held that the 6% commission income received with respect to orders from overseas customers, which were handled by non-Hong Kong based LFT's affiliates as offshore income, are not subject to profits tax in Hong Kong and there is no basis for apportionment of profits.

Our comments

Subsequent to the *ING Baring* case, the IRD tried to limit its application by stating that its principle should only apply to securities brokerage businesses. Even though the CFI's decision in the LFT case does not establish any new principle with regard to the locality of profits, it is encouraging to observe that the BoR and the CFI have consistently followed the principle established in *ING Baring*, and it was applied to a non securities brokerage business. Any antecedent or incidental activities, including the mere monitoring, supervisory or decision-making functions (usually referred as "brain analogy") generally are not considered relevant in determining the source of profits. The correct focus has to be the activities that give rise to the relevant gross profits.

The LFT case is particularly relevant to taxpayers earning service income where the services (or part thereof) are performed outside Hong Kong, even though the management and decision- making take place in Hong Kong. To better secure the likelihood of claiming relevant service fee income as offshore not subject to profits tax, careful planning and implementation of transactions are needed. Taxpayers are encouraged to undertake a critical review of their existing mode of operations, including contractual relationships with their service providers.

Finally, there was one interesting note in the CFI's decision. The judge noted that the BoR took three and a half years to hand down its decision after hearing the case, commenting that such a delay is not acceptable. Incidentally in a 2010 CFI ruling (*Yue Yuen Marketing Co. Ltd. and Others v CIR*), the CFI criticized the CIR's inordinate delay in issuing determinations on the taxpayer's objection. With the court's criticism of the two cases with respect to delays in processing objections and appeals (one on the IRD and one on the BoR), it is speculated that to avoid undue delay in tax processing and administration, the IRD might tighten its practice and become less lenient in granting extensions of time to taxpayers to furnish required supporting documentation to support their claims or defend their positions, and in the absence of sufficient information and documents, determine objections against taxpayers. It is therefore now even more important for taxpayers to maintain robust and proper documentation that can be furnished to the IRD promptly upon request.

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