CLIFFORD
CHANCE

Client briefing
May 2011

Hong Kong court ruled in favour of a taxpayer on its offshore claim

The Court of First Instance has recently delivered a judgment in favour of Li & Fung (Trading) Limited (**LFT**) in its tax dispute with the Inland Revenue. In its judgment, the Hong Kong Court has confirmed that the commission income earned by LFT was offshore and not chargeable to Hong Kong profits tax.

The facts

LFT carried on an agency business. On behalf of its customers, LFT undertook to source merchandise around the world. LFT was paid by the customers a commission for its services calculated on the basis of a percentage (say 6%) of the FOB value of the total export sales by them.

Many of LFT's services to the customers were provided outside Hong Kong, through local offices in other jurisdictions. In most cases, the local offices were LFT's affiliates, and LFT entered into contracts with its affiliates under which the affiliates would undertake to perform certain services. LFT paid a percentage (say 4%) of the FOB value of total export sales by its customers to its affiliates.

The Inland Revenue was of the view that the commission income earned by LFT on orders from overseas customers which were handled by LFT overseas affiliates was onshore profits and assessed profits tax on them. LFT objected to such assessments and appealed to the Board of Review.

The hearing of the Board of Review took place in 2006. The Board of Review delivered its decision on 12 June 2009. It held that profits relating to goods sourced from suppliers located in places other than Hong Kong were offshore and were not chargeable to profits tax.

The Inland Revenue was dissatisfied with the decision of the Board of Review. It appealed to the Court of First Instance on the question of the source of the commission income by way of case stated. The question before the Court of First Instance was the source of the commission income earned by LFT.

Dismissing the appeal of the Inland Revenue

At the Board of Review, the Inland Revenue sought to argue that LFT operated a "supply-chain management business", in which LFT's profit was the difference between the 6% it received from its customers and the 4% it paid its affiliates. Such case was rejected by the Board of Review – the Board of Review held that LFT carried on an agency business.

Before the Court of First Instance, the Inland Revenue reformulated its argument. It sought to argue that LFT's profit of 6% was earned as a result of activities carried out both in Hong Kong and abroad, and it was necessary for the Board to have apportioned the 6% to reflect what the affiliates did abroad and what LFT performed in Hong Kong. The Inland Revenue contended that the apportionment should be made in a way mirroring how LFT would split its commission with its affiliates, i.e. with 4% being attributable to the offshore activities of LFT's affiliates and the remaining 2% attributable to LFT's activities in Hong Kong.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Brian Gilchrist +852 2825 8878

Elaine Chen +852 2825 8956

Joseph Chu +86 10 6535 2284

To email one of the above, please use firstname.lastname@cliffordchance.com

www.cliffordchance.com

Mr. Justice Reyes rejected the reformulated argument of the Inland Revenue. He held that the Board of Review was correct to discern in a practical manner those activities of LFT which directly (as opposed to indirectly) led to the production of profits (which were the activities of its affiliates), and was right to disregard "antecedent activities" that were performed by LFT in Hong Kong. Accordingly, the Court dismissed the appeal of the Inland Revenue.

Our comments

Over the past several years, we have seen many cases in which the Inland Revenue and the taxpayers have different views on the relevant legal principles and the application of such legal principles on substantially undisputed facts. We have also noticed that many of the tax disputes, very often and unlike before, cannot be resolved out of court.

The judgment of Mr. Justice Reyes is a useful reminder to taxpayers (and the Inland Revenue) as to the correct legal principles in determining the question of the source of profits.

Two key points were highlighted by Mr. Justice Reyes. First, in determining the question of source, one must not investigate every facet of a taxpayer's operation and decide which matters are qualitatively the most important towards making a profit. Second, one must first identify the transaction which directly (as opposed to indirectly) gives rise to the relevant profits and must disregard all antecedent/incidental activities (even though they may be commercially essential to the taxpayer's operation and profitability).

Clifford Chance has represented LFT in successfully defending the Inland Revenue's appeal in the present case.