

Asia Pacific Tax Newsalert

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Hong Kong Court of Appeal reaffirms the source rule for commission income

Overview

The Hong Kong Court of Appeal, in *Li & Fung (Trading) Limited v CIR* (March 19, 2012), upheld the April 2011 judgment of the Hong Kong Court of First Instance. This confirms the Board of Review's decision that the taxpayer's commission income derived from sourcing goods from overseas suppliers on its customers' behalf was offshore and not subject to Hong Kong profits tax. The appellate court (the second-highest court in Hong Kong) therefore dismissed the Hong Kong Commissioner of Inland Revenue's appeal of the Board of Review's decision.

This newsalert summarizes the court case's facts and key findings.

The facts

The taxpayer serviced its overseas customers by sourcing products from suppliers (manufacturers) outside Hong Kong and overseeing manufacturing and other processes to ensure the supply of satisfactory goods. Both the customers and the suppliers were unrelated to the taxpayer. Upon delivery of the finished goods to its customers, the taxpayer was usually paid a commission equal to six percent of the total freight on board (FOB) value of the customer's export sales.

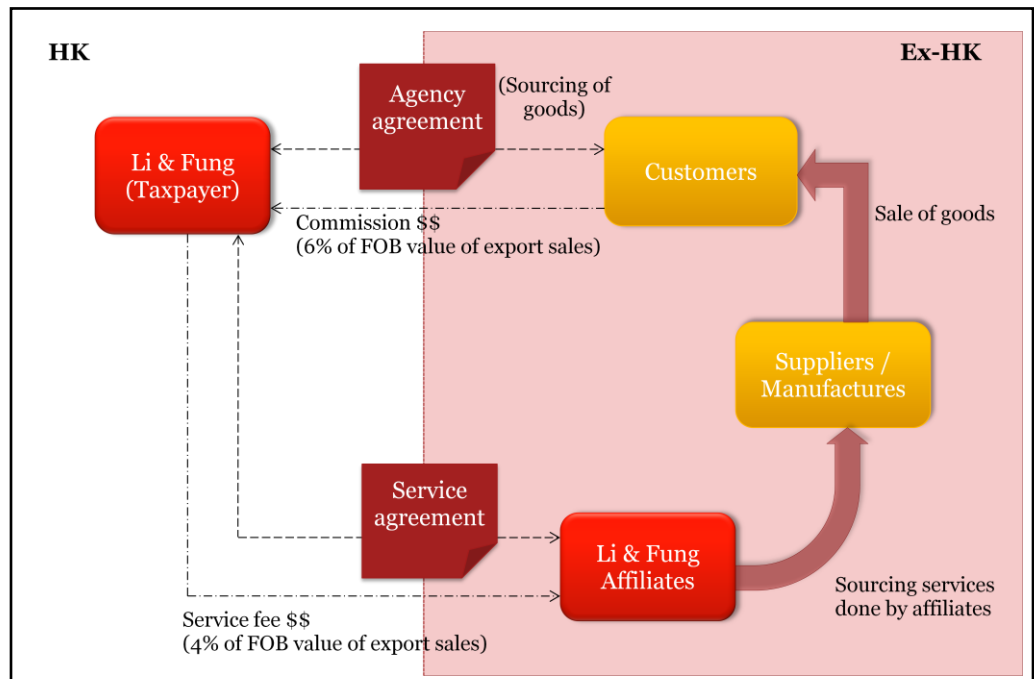


In most cases, the taxpayer entered into contracts with its overseas affiliates under which the latter performed the above services for the taxpayer outside Hong Kong. The taxpayer paid its affiliates a certain percentage of the FOB value of the customer's export sales in consideration for their services. The taxpayer's headquarters were in Hong Kong, and it entered into agency agreements with its customers as a result of its Hong Kong-based senior staff's efforts.

The taxpayer treated the commission income from these transactions as foreign source and not subject to Hong Kong profits tax. The taxpayer argued that the orders were from overseas customers and handled by affiliates not based in Hong Kong.

The Commissioner argued that the taxpayer's commission income should be subject to Hong Kong profits tax.

The diagram below summarizes the case:



The previous decisions

Both the Board of Review and the Court of First Instance ruled in the taxpayer's favor, holding that the commission income's source was offshore and the income therefore was not taxable in Hong Kong. The court determined that the board correctly focused on the services performed by the taxpayer's overseas affiliates on its behalf outside Hong Kong as the taxpayer's relevant profit-producing activities. In the court's view, the board also was entitled to disregard the activities performed by the taxpayer's senior management in Hong Kong as "antecedent activities."

The Court of Appeal's judgment

The Court of Appeal agreed with the Board of Review and the Court of First Instance that all of the taxpayer's profit-producing activities were performed outside Hong Kong, so it dismissed the Commissioner's appeal. One of the judgment's key points is the reaffirmation of the principle that, in determining the source of the taxpayer's profit, the focus must be on "establishing the geographical location of the taxpayer's

profits producing transactions themselves as distinct from activities antecedent or incidental to those transactions."

Conclusion

The Court of Appeal judgment underlines the important distinction between "activities that are commercially essential to the operations and profitability of a taxpayer" and "activities that provide the legal test for ascertaining the source of profits." In this case, the court concluded that the taxpayer derived its profits from the provision of sourcing services based on the terms of the standard agency agreement between the taxpayer and its customers. Once the taxpayer's income is determined to be in the nature of service-fee income, the performance of the services is the relevant activity to review when determining the source of profits. The activities performed in Hong Kong were regarded as "antecedent or incidental" as far as the source of profits is concerned.

Given the Court of Appeal's unanimous decision and the difficulty in raising additional facts or arguments on further appeal, we do not expect the Commissioner of Inland Revenue to appeal to the Court of Final Appeal, the highest court in Hong Kong.

Taxpayers with business operations similar to the taxpayer in *Li & Fung* that have not lodged an offshore claim in prior years should review their tax filing position.

Taxpayers planning to enter the Asia Pacific region may also wish to consider the taxpayer's facts in this case.

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