The Commissioner of Inland Revenue *(Appellant)*

and

Li & Fung (Trading) Limited *(Respondent)*

Court of First Instance
(Inland Revenue Appeal No. 3 of 2010)

Hon Reyes J
Date of Hearing : 6 April 2011
Date of Judgment : 18 April 2011

Court of Appeal
(Civil Appeal No. 86 of 2011)

Hon Tang VP, Hartmann JA and Chu JA
Dates of Hearing : 14–15 February 2012
Date of Judgment : 19 March 2012

Inland Revenue Ordinance (Cap. 112) – Profits Tax – section 14 – services relating to goods sourced from suppliers outside Hong Kong – whether profits arose in or were derived from Hong Kong – whether activities performed in Hong Kong antecedent or incidental matters – apportionment of profits

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The taxpayer, Li & Fung (Trading) Limited ("LFT"), was incorporated in Hong Kong and wholly owned by Li & Fung (B.V.I.) Limited ("LFBVI"), a company incorporated in the British Virgin Islands. LFBVI was wholly owned by Li & Fung Limited, a company listed on the Hong Kong Stock Exchange. LFT carried on a business in Hong Kong and had its headquarters in Hong Kong with many of its most senior staff based here.

LFT normally entered into contracts with customers for the provision of services. It provided services to its customers who were importers, department stores, chain stores and specialty shops located overseas for which, typically, LFT was paid 6% of the FOB value of the goods supplied to such customers. LFT in turn entered into service agreements with its overseas affiliates. Many of LFT's services to its customers, in practice, were carried out by its overseas affiliates outside Hong Kong. In consideration for the services provided, LFT paid its affiliates 4% on the FOB value of the merchandise.

LFT also entered into agreement with LFBVI under which LFBVI agreed to provide assistance and services to LFT and LFT agreed to pay LFBVI 2% of the FOB value of all export sales made by LFT for the services provided.

LFT contended that the profits relating to goods sourced from suppliers located in places other than Hong Kong, Mainland of China and Macau were offshore and so not chargeable to profits tax. The Commissioner argued before the Board that LFT operated a "supply-chain management business". LFT's profit was the difference between the 6% which it received from its customers and the 4% which it paid to its affiliates. LFT earned 2% for managing its own activities and those of its affiliates in Hong Kong.

On the other hand, LFT claimed that the fees paid to LFBVI was deductible under section 16(1) of the Inland Revenue Ordinance ("IRO") and the anti-avoidance provisions in sections 61 and 61A of the IRO were not applicable to such deductions.

The Board handed down its decision about 3 years and 6 months after the hearing. The Board held in LFT's favour on the source issue and in the Commissioner's favour on the section 61A issue.

The Board held that LFT was a "commission agent" and rejected the suggestion that LFT operated a "supply-chain management business". The Board found that the overseas sourcing affiliates were LFT's agents. All LFT's profits were earned in the place where the overseas sourcing affiliates carried out its instructions. The Board concluded that the disputed profits were all sourced outside Hong Kong and there was no question of apportionment.

Both parties appealed to the Court of First Instance. The Commissioner failed in his application for an amendment of the stated case to include the additional facts to show that the operations performed by LFT in Hong Kong did produce a profit split to LFT. Regarding the court's consideration of the section 61A issue, it was deferred pending remittal of certain matters to the Board.

On appeal by the Commissioner on the source issue, the Court of First Instance upheld the Board's decision, holding that there was ample evidence on which the Board could come to the conclusion which it did. The Commissioner appealed to the Court of Appeal.

The essence of the Commissioner's case in the Court of Appeal is that the economic activities or operations performed by LFT in Hong Kong were expressly agreed under the agreements with customers and were carried out by LFT in Hong Kong when performing the terms of the agreements. These profit generating activities or operations took place in Hong Kong and the profits attributable to those activities or operations should have been sourced in Hong Kong.

Held by the Court of Appeal, dismissing the appeal, that:

(1) The relevant legal principles on the question of source of profits were the broad guiding principle laid down in *CIR v HK-TVB International Ltd (P.C.) [1992] 2 AC 397*, i.e. what the taxpayer has done to earn the profit in question and where he has done it, and the emphasis on focusing the effective causes to the profit-producing transactions as distinct from other activities antecedent or incidental to those transactions as stated in *Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275* and *ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417*.

(2) The judgment of the Court of First Instance was amply justified by the facts found by the Board.

(3) The Board could not be blamed for not dealing with the Commissioner's argument raised in the Court of Appeal.

(4) The Board had made the material findings of fact and had given sufficient reasons, and the Board's delay in handing down its decision would not render the decision unsafe.

(5) There was no basis to remit the case back to the Board to make additional findings of fact or to enable the Commissioner to advance a new case on apportionment.

In the Court of First Instance

Mr. Benjamin Yu, SC and Mr. Eugene Fung (instructed by Department of Justice) for the Commissioner of Inland Revenue

Mr. David Goldberg, QC and Mr. Stewart K. M. Wong (instructed by Messrs Clifford Chance) for the respondent

In the Court of Appeal

Mr. Benjamin Yu, SC and Mr. Eugene Fung (instructed by Department of Justice) for the Commissioner of Inland Revenue

Mr. David Goldberg, QC and Mr. Stewart K. M. Wong, SC (instructed by Messrs Clifford Chance) for the respondent

Cases referred to in the judgment of the Court of Appeal:

CIR v HK-TVB International Ltd (P.C.) [1992] 2 AC 397

CIR v Inland Revenue Board of Review and Anor [1989] 2 HKLR 40

CIR v Quitsubdue Ltd [1999] 2 HKLRD 481

Cobham v Frett [2001] 1 WLR 1775

ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417

Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275