

Commissioner's appeal in a source of profits case dismissed by the Court of Appeal

This briefing is a follow-up to our previous briefing "Hong Kong court ruled in favour of a taxpayer on its offshore claim" issued in May 2011. A copy of our previous briefing can be found [here](#).

Background

By way of background, Li & Fung (Trading) Limited ("LFT") was in dispute with the Inland Revenue on its offshore claim. Both the Board of Review and the Court of First Instance held that the commission income earned by LFT was offshore source and not chargeable to Hong Kong profits tax.

The Inland Revenue was dissatisfied with the rulings, and appealed to the Court of Appeal on the question of the source of the commission income by way of case stated.

Key issues

- Background
- Appeal dismissed by the Court of Appeal
- Our comments

Appeal dismissed by the Court of Appeal

The Court of Appeal heard the appeal of the Inland Revenue in February 2012 and has recently delivered its judgment, dismissing the Inland Revenue's appeal.

At the Court of Appeal hearing, the Inland Revenue sought to run an argument different from its argument at the Board of Review: at the Board of Review, the Inland Revenue argued that LFT operated a "supply-chain management business"; at the Court of Appeal, however, it sought to argue that LFT carried on an agency business, and an apportionment should have been made to reflect the fact that some of the relevant profit making activities were carried out by LFT in Hong Kong and some were carried out by LFT's affiliates outside Hong Kong.

The Court of Appeal dismissed the Inland Revenue's appeal.

In its decision, the Court of Appeal held that the Board had applied the correct legal principles and made findings of fact which could sufficiently justify its conclusion on the source of profits, including that (i) LFT carried on an agency business (and not a "supply chain management" business); (ii) all the relevant profit producing transactions of LFT took place outside Hong Kong; and (iii) all activities happening in Hong Kong were antecedent activities. The Inland Revenue's complaint that the Board failed to make factual findings on relevant matters was not accepted by the Court of Appeal, which held that the Board could not be blamed for not dealing with a matter which was not raised before it (but only raised by the Inland Revenue in its reformulated case before the Court of Appeal). Hence, the Court of Appeal refused to remit the matter to the Board to enable the Inland Revenue to advance a new case on apportionment.

Our comments

In determining the source of profits, it is important to properly and accurately identify the nature of the taxpayer's business. Such identification is important because an activity can be regarded as profit-generating in one type of business, but may be regarded as purely antecedent or incidental in other types of business. For example, management activities may be regarded as profit-generating in a truly "supply-chain management" business, but they would be regarded as antecedent in a "sourcing business", as found by the courts in the present case. Hence, this case is a useful reminder to tax practitioners that one must have an accurate grasp of the nature of the business carried on by the taxpayer before embarking on any investigation as to the geographical source of the profit making activities of that taxpayer.

Finally, while the amount of tax in dispute well exceeds HK\$1 million, the Inland Revenue does not have an automatic right of appeal to the Court of Final Appeal, as confirmed by the Appeal Committee in *Commissioner of Inland Revenue v. CG Lighting*, FAMV23/2011, dated 24 August 2011. Unless the Inland Revenue can establish that this case involves questions of great general public importance or there are exceptional circumstances which necessitate the Court to exercise its discretion to grant permission to appeal to the Court of Final Appeal, the decision of the Court of Appeal in this matter will be final.

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

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