

HCIA 1/2010

**IN THE HIGH COURT OF THE  
HONG KONG SPECIAL ADMINISTRATIVE REGION  
COURT OF FIRST INSTANCE**  
INLAND REVENUE APPEAL NO. 1 OF 2010  
(transferred from the Board of Review Hearing No. B/R 39/04)

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BETWEEN

LI & FUNG (TRADING) LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

AND

HCIA 3/2010

**IN THE HIGH COURT OF THE  
HONG KONG SPECIAL ADMINISTRATIVE REGION  
COURT OF FIRST INSTANCE**  
INLAND REVENUE APPEAL NO. 3 OF 2010

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BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

LI & FUNG (TRADING) LIMITED Respondent

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(Heard together)

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Before: Hon Reyes J in Court

Date of Hearing: 6 April 2011

Date of Judgment: 18 April 2011

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J U D G M E N T

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**I. INTRODUCTION**

1. The Taxpayer (LFT) is wholly-owned by LFBVI (a BVI company).
2. There were two issues in LFT's appeal against the Commissioner's assessment of profits tax. The first was whether LFT's profits relating to goods sourced from suppliers located in places other than Hong Kong were offshore and so not chargeable to profits. The second was whether LFT's deduction of a 2% marketing commission (paid to LFBVI) from onshore profits was caught by the anti-avoidance provisions in ss.61 and 61A of the Inland Revenue Ordinance (Cap.112) (IRO).
3. The Board decided in LFT's favour on the first issue and in the Commissioner's favour on the second. Both parties appealed by way of case stated against the Board's Decision. It has been agreed that the Court's consideration of the second issue be deferred, pending remittal of certain matters to the Board.
4. Consequently, the present appeal hearing only concerned the first issue. On that, the Board stated the following question for my determination:-

“Whether, on the facts found by the Board, the true and only reasonable conclusion contradicts the Board's conclusion at paragraphs 86 and 95 of the Decision, namely, that all of LFT's disputed profits were sourced outside Hong Kong and no apportionment would arise?”

5. Under IRO s.14 tax is chargeable on profits arising in or derived from a trade, profession or business carried out in Hong Kong. LFT paid profits tax on its profits relating to goods sourced from suppliers in Hong Kong. LFT disputed the Commissioner's assessment of tax on profits relating to goods sourced from suppliers outside of Hong Kong. In paragraphs 86 and 95 of its Decision, the Board held that “the disputed profits were all sourced outside Hong Kong and there is no question of apportionment”.

**II. BACKGROUND**

6. LFT provides services to its customers in connection with the manufacture, sale and purchase of goods. Such services include finding suppliers to manufacture and then sell goods to LFT's customers as buyers. LFT manages the sourcing and

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manufacturing processes to ensure that satisfactory goods are supplied to its customers. Upon delivery of the finished goods to its customers, LFT is usually paid a commission (6% of the total FOB value of the customer's export sales).

7. LFT normally enters into contracts with customers for the provision of LFT's services. Under those agreements LFT is appointed as the buying agent of LFT's customer (identified as the principal). A typical agency agreement lists the following as the specific services to be provided by LFT to a customer:

- “(a) Locate suppliers, arrange manufacture, place orders in the Territory [of the supplier] on behalf of the Principal under the Principal's standard terms & conditions of trading. The Agent shall have no authority to place an order for goods without having first received written authorisation from the Principal.
- (b) Keep close contact with the Suppliers to ensure that production is running according to the delivery schedule set by the Principal for each item.
- (c) Maintain quality control on merchandise including inspection and on a random basis to ensure that items being produced conform to the Principal's requirements.
- (d) Arrange for the shipment of the Merchandise under instruction of the Principal, including assisting the Supplier where necessary with the preparation of all relevant export documentation.
- (e) Attempt to settle possible merchandise claims on behalf of the principal.
- (f) Endeavour to keep the Principal advised from time to time of new developments in markets of the Territory which may be of interest to the Principal.
- (g) Sign or countersign contracts/ purchase orders/ commitment on Principal's behalf.”

8. LFT, the sellers who manufacture goods, and LFT's customers who buy the manufactured goods from the sellers, are all independent of each other.

9. Many of LFT's services are provided outside Hong Kong through local offices. The local offices usually have their own staff. In most cases, the local offices are LFT affiliates. LFT engages or acts through these local affiliates or sourcing companies in performing the services which LFT has contracted to provide to its customers.

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10. LFT has entered into contracts with its affiliates under which the latter have in turn undertaken to perform certain services. A typical agreement identifies the services to be provided by an affiliate as follows:

- “(a) to research and locate suppliers for products and goods which the Company [LFT’s customer] may require from time to time and generally to coordinate the supply of and demand for products provided by the Company between suppliers and customers and to advise the Company in respect of sourcing of products;
- (b) to furnish continuous information concerning products availability, market conditions, and, in particular, information concerning the Company’s suppliers and advise on matters of pricing;
- (c) to arrange and obtain samples of products from suppliers and to assist the Company’s suppliers with any problems relating to the exportation or application for export license of goods;
- (d) to assist and advise on methods of transporting, storing and delivery of goods from the Company’s suppliers and to provide advice regarding packaging systems and materials most suitable for goods;
- (e) to assist the Company in investigating and settling any claims and complaints against products or goods supplied;
- (f) to arrange for the packaging and shipping of the goods or products as shall be purchased by the Company and/or its customers and to act on and in accordance with the instructions of the Company in connection with such matters;
- (g) to provide inspectors to monitor quality control of products offered by the Company whenever such quality control services are required by the Company ...;
- (h) to do such other acts and things as the Company and [LFT] shall from time to time mutually agree.”

11. In consideration for an affiliate’s services, LFT paid the latter a percentage (say 4%) of the FOB value of total export sales by LFT’s customer.

12. LFT has its headquarters in Hong Kong with many of its most senior staff based here. LFT enters into agency agreements with its customers as a result of the efforts of its senior staff.

13. In computing liability to Hong Kong tax, LFT excluded from its profits the commission earned on orders from overseas customers which were handled by non-Hong

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Kong based LFT affiliates. LFT took the view that such commission was foreign source income and so not chargeable to Hong Kong profits tax.

14. In contrast, the Commissioner argued before the Board that LFT's profit was the difference between the 6% which it received from its customers and the 4% which it paid to its affiliates. The Commissioner suggested that LFT operated a "supply-chain management business". In consequence, whereas LFT's affiliates earned their 4% for activities abroad, LFT (the Commissioner reasoned) earned 2% for managing its own activities and those of its affiliates from LFT's Hong Kong headquarters.

15. The Board did not accept the Commissioner's case.

16. The Board held that LFT was "a commission agent". LFT's business was "that of undertaking, on behalf of its own customers, the sourcing of merchandise for its customers". In short, LFT "sold services for commission".

17. On the basis (among others) of the contracts between LFT and its local affiliates, the Board further found that the latter were LFT's agents. The Board rejected the Commissioner's suggestion that the affiliates were sub-contractors whom LFT had employed to perform services which LFT had agreed to perform for its customers.

18. The Board noted that "LFT employed the local LF [Li & Fung] sourcing companies to act for LFT in carrying out transactions for [LFT's] customers". It followed from this that "LFT's profits were earned in the place where the LF sourcing companies carried out LFT's instructions, whether they [the LF sourcing companies] did so as agents or principal".

19. More particularly, "LFT contracted to render a service to its customers, and its net commission, after paying the local LF sourcing companies 4%, arose in the place where it rendered it [the service], i.e., offshore". The Board emphasised that the focus had to be on "establishing the geographical location of LFT's profit producing transactions themselves as distinct from activities antecedent or incidental to those transactions".

20. The Board continued (at Decision, para. 84):

"The profit producing activities or services started from the placement of orders by LFT's customers with suppliers, continued throughout the whole process of the production of the merchandise until the successful conclusion of the orders by shipments of the merchandise to the customers and in some cases continued further until the conclusion of follow-up services. It was through those transactions or activities that LFT earned its commissions and charges which were payable only after the completion of the shipment of the merchandise. LFT employed the local LF sourcing companies to act for LFT in carrying out these profit producing activities or services. It mattered not whether the local LF sourcing companies were LFT's agents or sub-contractors. We find as a fact that all the profit producing/making activities/transactions took place

outside Hong Kong. We further find that the geographical source of LFT's net commission representing the difference between the commission it paid to the local LF sourcing companies which performed the sourcing services and the larger commission which it charged to its own customers arose outside Hong Kong."

21. In coming to its conclusions, the Board stated that it was applying the principles articulated by the Court of Final Appeal (CFA) in *ING Baring Securities (Hong Kong) Ltd. v. CIR* (2007) 10 HKCFAR 417.

### **III. DISCUSSION**

#### **A. Law**

22. In *ING Baring*, the CFA criticised an approach to profits tax which fixed the geographical location of a taxpayer's profits by reference to "activities antecedent or incidental to those transactions". Ribeiro PJ commented (at para. 38):

"Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of s.14."

23. In support, the CFA (among other cases) cited *Commissioner of Income Tax, Bombay Presidency and Aden v. Chunilal B Mehta of Bombay* (1938) LR 65 Ind App 332, a decision of the Privy Council on appeal from British India. In *Mehta*, the Privy Council stated (at 345) that:

"[t]o determine the place at which ... a profit arises not by reference to the transaction, or to any feature of the transaction, but by reference to a place in India at which the instructions therefor were determined on and cabled to New York is ... to proceed in a manner which cannot be supported".

24. The CFA stressed in *ING Baring* that, to determine the source of a profit, one must first identify the transaction which directly gives rise to the profit. If that transaction takes place in Hong Kong, then the profit generated may be charged with profits tax under IRO s.14. Otherwise, the transaction will have taken place offshore and profits tax will not be chargeable. The latter will be the result even though a taxpayer is present or normally resident in Hong Kong at the time when the transaction takes place.

25. Ribeiro PJ expressed the foregoing more vividly by rejecting (at para. 48) any resort to a "brain" metaphor (that is, reference to where the "brains" or decision-makers of a business are located) for the purposes of determining the geographical source of a profit:

"Use of a 'brain' analogy or the place of administration of the business as criteria for ascertaining the geographical source of profits is plainly

inconsistent with the decisions in Mehta and Hang Seng Bank. In a case like the present, source is determined by the nature and situs of the profit-producing transaction and not by where the taxpayer's business is administered or its commercial decisions taken.”

26. This meant (Ribeiro PJ commented) that in ING Baring the Board of Review had embarked on a costly but ultimately pointless (“legally irrelevant”) exercise. Specifically, the Board had been wrong:

“to investigate every facet of the Taxpayer’s business so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing ‘the more important things done’ towards the generation of those profits as the criteria for determining geographical source”.

27. In *Ngai Lik Electronics Co Ltd. v. CIR* (2009) 12 HKCFAR 296 the CFA repeated what it had said in *ING Baring*.

28. Ngai Lik bought goods which its offshore subsidiaries manufactured in the Mainland. Ngai Lik onsold those goods to customers in Hong Kong. Ngai Lik also engaged in sourcing and agency activities in support of its offshore manufacturing subsidiaries. The Commissioner charged Ngai Lik for profits arising from manufacturing and trading activities.

29. Ribeiro PJ (at para.69) acknowledged that, where a person received payment (such as commission) for sourcing and agency activities carried out in Hong Kong, that payment might be chargeable with profits tax.

30. But in *Ngai Lik*, Ribeiro PJ was “unable to see how any profits derived from the taxpayer’s sourcing and agency activities can properly be described as manufacturing profits or used as a basis for treating part of the fellow subsidiaries’ profits as the taxpayer’s profits”. Instead, Ribeiro PJ thought that Ngai Lik’s sourcing and agency activities were “at most ancillary to the offshore manufacturing operations which actually produced ‘manufacturing profits’ which arose only upon disposal of the manufactured goods”.

31. It followed that the source of the Ngai Lik Group’s manufacturing profits (as opposed to profits obtained from sourcing or agency activities) could not be Hong Kong.

## **B. Commissioner’s reformulated case in this appeal**

32. Mr. Benjamin Yu SC (who appeared before me (but not the Board) on behalf of the Commissioner) reformulated the Commissioner’s case. Mr. Yu did not press the submission that LFT was carrying out a “supply-chain management business”. Instead, Mr. Yu argued that the Board had erred in not apportioning the gross profit of 6% which LFT received from its customers.

33. LFT's profit of 6% (Mr. Yu contended) was earned as a result of activities carried out both in Hong Kong and abroad. Insofar as non-Hong Kong based affiliates were involved, Mr. Yu accepted that some of LFT's profit had an overseas source. On the other hand, insofar as LFT managed and supervised its affiliates from Hong Kong, part of LFT's profits (Mr. Yu argued) must have had a Hong Kong source.

34. Mr. Yu submitted that LFT's profits could not have been generated through the activities of LFT's affiliates alone. The management and supervision of those affiliates (Mr. Yu said) were key factors in producing profits. Mr. Yu stressed that, without the element of management and supervision provided by LFT from Hong Kong, merchandise could not have been delivered to LFT's customers and commission could not have been earned.

35. Mr. Yu criticised the Board for failing to consider each of the activities (a)-(h) set out in the standard agency agreements between LFT and its customers. Had the Board done its job properly, it would have appreciated that, as a matter of fact, activities (a)-(d) required certain matters to be done or resources to be maintained in Hong Kong to enable a 6% commission to be successfully earned.

36. According to Mr. Yu, the Board wrongly applied ING Baring.

37. It was necessary (Mr. Yu concluded) for the Board to have apportioned the 6% to reflect what the affiliates did abroad and what LFT performed here. Mr. Yu was content for apportionment to mirror the way in which LFT split its 6% commission, with 4% being attributable to the offshore activities of LFT's affiliates and 2% being attributable to LFT's activities in Hong Kong.

38. I am not persuaded by Mr. Yu's argument.

**C. Analysis of Commissioner's reformulated case**

39. In my view, the Board did precisely what the CFA says the Board had to do. As required by ING Baring, the Board had to (and did) identify the activities giving rise to the relevant gross profit.

40. Here (the Board held) what generated LFT's gross commission of 6% were sourcing and agency activities which LFT carried out through overseas local affiliates. The latter affiliate companies (acting on behalf of LFT) assisted LFT's customers in placing orders with offshore sellers, supervised the manufacturer by those sellers of goods to the specifications of LFT's customers, and arranged for the shipment of the finished goods from the sellers to LFT's customers. It was those activities (the Board found) which directly led to the payment of a gross commission of 6%. Those activities took place outside Hong Kong. Without those activities (in particular, the successful delivery of merchandise to LFT's customer), no commission of 6% could have been earned.

41. There was ample evidence on which the Board could come to the conclusion which it did. For instance, Agreed Fact 4 in the appeal hearing states:



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“Through a network of sourcing offices around the world, LFT organised and arranged the manufacture of soft goods (such as garments) and hard goods (such as fashion accessories, gifts, handicrafts, home products, promotional merchandise, toys, sporting goods, footwear and travel goods).”

42. It is true that LFT maintained back-up or support services for its affiliates at its Hong Kong headquarters. But the Board was entitled to disregard the same as merely (in the words of Ribeiro PJ in *ING Baring*) “antecedent activities” which although “commercially essential to the operations and profitability of [LFT’s] business ... do not provide the legal test for ascertaining the geographical source of profits”.

43. Mr. Yu sought to make good his characterisation of LFT’s 6% commission as having both an overseas and a Hong Kong source. He attempted this by running through each of the activities (a)-(h) mentioned in the standard agreement between LFT and a customer.

44. In respect of activities (f) and (g) (respectively, keeping a customer informed of market developments and signing contract-related documents for a customer), Mr. Yu accepted that those activities took place entirely outside Hong Kong. Activity (h) is simply a general catchall provision.

45. In respect of activity (a) (locating suppliers, arranging manufacture, and placing orders for a customer), Mr. Yu suggested that senior staff would not only have supervised the local affiliates from Hong Kong, but the local affiliates would themselves have relied from time to time on the intimate regional knowledge and experience possessed by senior staff based in Hong Kong.

46. In respect of activity (b) (ensuring that production of merchandise runs smoothly and on time), Mr. Yu relied on the presence in Hong Kong of senior staff who “monitored the performance of the overseas sourcing companies to make sure that everything was done efficiently” (Agreed Fact 8). Mr. Yu also referred to the manner in which (according to an excerpt from an interview of LFT’s Victor Fung in the September 1998 issue of *Harvard Business Review* recorded in Agreed Fact 9) LFT serviced its customer Gymboree. According to Victor Fung, LFT’s Gymboree division was one of its largest and LFT devoted a separate office within the Li & Fung building in Hong Kong to providing Gymboree with the requisite technical and merchandising support.

47. In respect of activity (c) (maintaining quality control), Mr. Yu again pointed to the overall supervisory work done by senior staff in Hong Kong.

48. In respect of activity (d) (arranging shipment of merchandise), Mr. Yu pointed to the evidence of William Fung (an LFT and LFBVI director) that “the payment process was centralised in Hong Kong”. He also cited the evidence of John Heaviside (a representative from Mackays, an LFT customer) that “payments arranged by LF to the suppliers were provided ‘centrally’ from LF”. Thus, Mr. Yu inferred that merchandise

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shipments to customers must initially have been paid on behalf of the latter through LFT's Hong Kong office.

49. In respect of activity (e) (assisting in investigating and settling claims), Mr. Yu referred to Agreed Fact 5(8). That states: "When problems were encountered which they could not solve themselves, G2s [Grade 2 staff] would seek guidance and direction from the G1s [Grade 1 staff]." Mr. Yu suggested that, where a local affiliate was unable to settle a claim, it would undoubtedly seek help from LFT's senior staff in Hong Kong.

50. Mr. Yu's argument seems to me to be precisely the "brain analogy" which the CFA criticised in ING Baring. Mr. Yu denies this.

51. According to Mr. Yu, his submission differs from the brain analogy by focusing on the availability in Hong Kong of senior personnel ("a human database") on whose experience and knowledge junior staff of local affiliates would inevitably have to refer. But I am not persuaded that there is any real difference with the brain analogy. To my mind, Mr. Yu is saying no more than that at the material times LFT's senior administrative staff based in Hong Kong oversaw the activities of various overseas affiliates within the Li & Fung group. That fact alone (the CFA has said in ING Baring and Ngai Lik) is not an appropriate criterion for ascertaining the geographical location of a profit.

52. Mr. Yu complains that the Board failed to analyse what specific operations were involved in carrying out activities (a) to (e). The Board (Mr. Yu contends) therefore failed in its duty to make findings as to which specific operations within those activities (a) to (e) took place in Hong Kong and which did not. Absent such findings, it was impossible (Mr. Yu suggests) for the Board to conclude as it did.

53. I disagree.

54. For the Board to have embarked on the investigation indicated by Mr. Yu would have been to engage in what the CFA described in ING Baring as a "legally irrelevant" exercise. It was not the Board's function to investigate every facet of LFT's operations and then decide which matters were qualitatively the most important towards making a profit. What instead had to be done was what the Board actually did. That was to discern in a practical manner those activities of LFT which directly (as opposed to indirectly) led to the production of profits.

55. In my view the Board's findings and conclusions on the source of LFT's profits are unassailable. There is no basis for saying that the Board ought to have apportioned the 6% commission in the way Mr. Yu suggests. Nor can it be said that the Board acted irrationally or that its conclusions were unsupported by the available evidence.

56. I would answer "No" to the question posed by the Board for this Court's determination.

#### IV. CONCLUSION

57. The Commissioner's appeal against the Board's conclusion on the source of LFT's disputed profits fails. There will be an Order Nisi that the Commissioner pay LFT's costs of the appeal in relation to the source of LFT's disputed profits. Costs are to be taxed if not agreed, with certificate for two counsel.

58. Before leaving this matter, I should touch on two matters.

59. First, the hearing before the Board ended on 19 January 2006. But the Board did not hand down its Decision until 12 June 2009, nearly 3 years and 6 months later.

60. I fully appreciate that Board members give up their valuable time in order to render voluntary public service for little or no remuneration. But it seems to me that, by any standard, a delay of 3½ years in handing down a Decision must be unacceptable.

61. A Board should endeavour to hand down its Decision within a reasonable time after a hearing. The parties to the proceedings (especially, the Taxpayer) are entitled to know where they stand in a dispute as soon as reasonably possible.

62. In the normal course of events, I suggest that it would generally be reasonable to expect a Board to hand down a Decision within 6 months of a hearing. There may be circumstances where a longer time frame might be justified. But such situations must be exceptional.

63. Second, a substantial part of the Decision consisted of a summary of the evidence given by LFT's many factual witnesses. There was little indication in that summary what evidence the Board was accepting and what (if any) evidence the Board was rejecting. It was unclear whether the Board intended the summary to represent its findings of fact.

64. A summary of what witnesses say in the course of some hearing is of little help by itself. What is more important is for a Board to identify precisely what findings of fact it is making.

65. On occasion the parties will have differing versions of what happened in the course of key events. In that case, a Board may wish to summarise the evidence adduced by each party in support of their competing versions. However, the Board should not stop there. The Board should go on to specify which parts of each side's evidence it accepts and why.

(A. T. Reyes)

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Judge of the Court of First Instance  
High Court

Mr. Benjamin Yu, SC and Mr. Eugene Fung, instructed by the Department of Justice, for the Appellant in HCIA 3/2010 and the Respondent in HCIA 1/2010

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