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In this issue:

Hong Kong court confirms *ING Baring* source principle for commission income

On 18 April 2011, the Court of First Instance (CFI) of the Hong Kong SAR handed down its judgment in *Commissioner of Inland Revenue v. Li & Fung (Trading) Limited* (HCIA 3/2010). The decision was in favor of the taxpayer, Li & Fung (Trading) Limited (LFT), and confirmed the earlier decision of the Board of Review (BoR) that LFT's commission income with respect to goods sourced from foreign suppliers was offshore and, therefore, not chargeable to Hong Kong profits tax.

Hong Kong operates a territorial tax system, according to which only profits that have a source in Hong Kong are assessable to profits tax. The guiding principle in determining source is clear, i.e. what has the taxpayer done to generate the profits in question and where has he done it. In essence, it is necessary to identify the activities that produced the relevant profits and where those activities took place. While the principle seems simple, the application of the source of profits rule in individual cases has been a contentious issue between the Inland Revenue Department (IRD) and taxpayers. The issue arises because, among all the operating activities of a business, it is difficult to objectively identify income-generating activities and often difficult for the IRD and the taxpayer to reach a consensus without the case ending up in court.

In practice, the determination of the source of profits was evolving from a simple contract test to a "totality of facts" approach before the *ING Baring* case (decided by the Court of Final Appeal (CFA) in 2007). The totality of facts approach was generally criticized as cumbersome and it sometimes led to a result that was inconsistent with the territorial concept of taxation in Hong Kong, which had the potential to weaken Hong Kong's competitive position as an offshore territorial tax regime.

The CFA's decision in *ING Baring* represented a paradigm shift in the application of the source rule from the totality of facts approach that was normally used by the IRD to determine the source of profits in Hong Kong. The CFA's decision stressed the need to ascertain the geographic location of the taxpayer's income-generating transactions, i.e. the effective causes, rather than other activities antecedent or incidental to those transactions.

The CFI's decision in *Li & Fung* follows the direction of the source principle that was established in *ING Baring*.

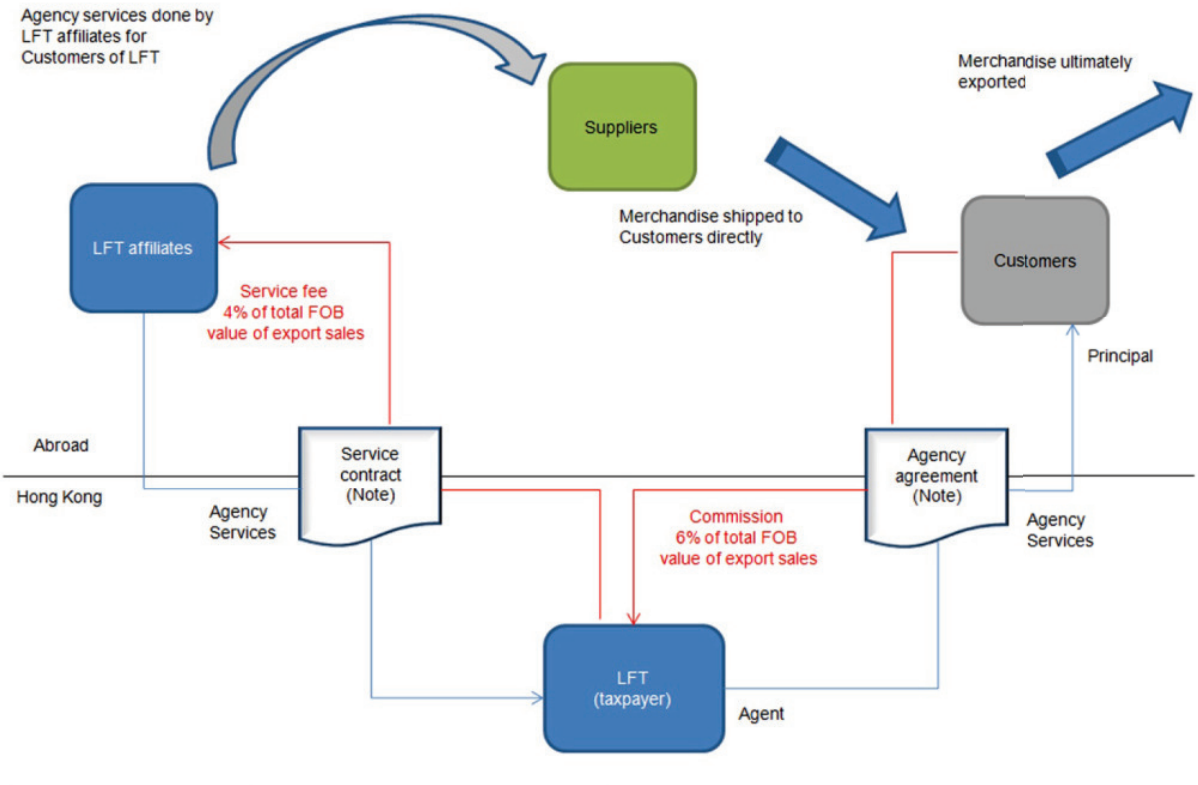
Facts

LFT carries on a business in Hong Kong that provides services to its customers abroad. Under an agency agreement between LFT (Agent) and its customer (Principal), the services to be provided by LFT include, on the Principal's behalf, locating suppliers to carry out manufacturing and placing orders (with prior written authorization from the Principal) with suppliers in their respective locations, both locally and abroad; maintaining quality control of merchandise produced by suppliers; arranging for the shipment of merchandise; assisting the Principal with settling potential merchandise claims against suppliers; providing the Principal with up-to-date information on new developments in markets where the suppliers are located; and signing or countersigning contracts/purchase orders/commitments for the Principal.

LFT also enters into service contracts with its affiliates overseas. Many of LFT's services described above, in practice, are carried out by LFT's overseas affiliates outside Hong Kong.

Upon delivery of merchandise to the customers, LFT is paid a commission that equals 6% of the total FOB value of the customer's ultimate export sales ("6% commission income"). LFT paid its affiliates that carried out the services 4% of the FOB value of the total export sales of the customers ("4% service fee").

The suppliers, customers and LFT were independent parties. The following diagram outlines the key facts of the case:



Note: Details of contract negotiation and conclusion not stated in transcript of the case.

Dispute

The IRD assessed profits tax on LFT's commissions earned on orders from overseas customers that were handled by LFT's non-Hong Kong-based affiliates. LFT took the position that the 6% commission income was offshore income and not assessable to profits tax in Hong Kong. LFT objected to the IRD's assessment and appealed to the BoR with regard to the tax liability in dispute.

Arguments of IRD

The IRD argued before the BoR that LFT was actually operating a "supply-chain management business," whereby it received commission income based on 6% of the customer's export sales value and at the same time paid its affiliates overseas the 4% service fee. Further, the Commissioner of Inland Revenue (CIR) suggested that the overseas affiliates were subcontractors employed by LFT. The difference of 2% earned by LFT represented the management of LFT's own activities and those of its affiliates from LFT's headquarters in Hong Kong. The commission income thus has a Hong Kong source and should be taxable.

Decision of the BoR

The BoR disagreed with the CIR, emphasizing that, in determining the source of the commission income, the focus had to be on "establishing the geographic location of LFT's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions."

The BoR held that LFT was "a commission agent," for which it employed the affiliates abroad as agents (as opposed to subcontractors) to act for LFT in carrying out the agency services for the customers. LFT's profits were earned in the place where the LFT's affiliates carried out LFT's instructions overseas. Therefore, the commission income is not sourced in Hong Kong and should not be assessable.

CIR reformulated arguments

The CIR was dissatisfied with the BoR's decision, and the case was brought before the CFI. The IRD changed its argument slightly in the CFI proceedings: instead of pursuing the argument that LFT was carrying out a supply-chain management business in Hong Kong, the IRD argued that the agency services agreed between LFT and its customers could not be performed by the LFT's foreign affiliates on their own. The management and supervision of those affiliates overseas by LFT in Hong Kong were also key factors in producing the commission income. LFT's commission income of 6%, which it received from the customers, was earned as a result of activities carried out both in Hong Kong and abroad and, therefore, should be apportioned. The CIR argued that the apportionment should be to split the 6% commission, with 4% being attributable to the offshore activities of LFT's affiliates and 2% attributable to LFT's activities in Hong Kong.

Decision of the CFI

The judge of the CFI confirmed both the decision and the analysis of the BoR. The judge noted that the BoR correctly followed the *ING Baring* principles as articulated by the CFA, i.e. identify the activities giving rise to the relevant gross profit. The CFI agreed with the BoR that LFT's affiliates overseas, which acted on behalf of LFT, assisted LFT's customers in placing orders with suppliers overseas, supervised the production of merchandise made by the suppliers to the specifications of LFT's customers and arranged for the shipment of the merchandise from the suppliers to LFT's customers. In the absence of these sourcing and agency activities that LFT carried out through its affiliates abroad, LFT would not be able to earn the 6% commission income. All of these activities took place outside Hong Kong.

In handing down the CFI's decision, the judge commented that it is true that LFT maintained management and supervisory support services for its overseas affiliates in Hong Kong, but these were "antecedent activities" that, although "commercially essential to the operations and profitability of [LFT's] business …, do not provide the legal test for ascertaining the geographic source of profits." The judge disagreed with the IRD's arguments before the CFI and held that the 6% commission income received with respect to orders from overseas customers, which were handled by LFT's non-Hong Kong-based affiliates as offshore income, are not subject to profits tax in Hong Kong and there is no basis for apportionment of profits.

Comments

Even though the CFI's decision in the LFT case does not establish any new principle with regard to the locality of profits, it is encouraging to observe that the BoR and the CFI have consistently followed the principle established in *ING Baring*. Any antecedent or incidental activities, including the mere monitoring, supervisory or decision-making functions (usually referred to as "brain analogy"), generally are not considered relevant in determining the source of profits. The correct focus has to be the activities that give rise to the relevant gross profits.

The *Li & Fung* case is particularly relevant to taxpayers earning service income where the services (or parts thereof) are performed outside Hong Kong, even though the management and decision-making take place in Hong Kong. To better secure the likelihood of claiming relevant service fee income as offshore income not subject to profits tax, careful planning and implementation of transactions are needed. Taxpayers are encouraged to undertake a critical review of their existing mode of operations, including contractual relationships with their service providers.

Finally, there was one interesting note in the CFI's decision. The judge noted that the BoR took three and a half years to hand down its decision after hearing the case, commenting that such a delay is not acceptable. Incidentally in a 2010 CFI ruling (*Yue Yuen Marketing Co. Ltd. and Others v. CIR*), the CFI criticized the CIR's inordinate delay in issuing determinations on the taxpayer's objection. With the court's criticism of the two cases with respect to delays in processing objections and appeals (one on the IRD and one on the BoR), it is speculated that, to avoid undue delay in tax processing and administration, the IRD might tighten its practice and become less lenient in granting extensions of time to taxpayers to furnish required supporting documentation to support their claims or defend their positions, and, in the absence of sufficient information and documents, determine objections against taxpayers. It is therefore now even more important for taxpayers to maintain robust and proper documentation that can be furnished to the IRD promptly upon request.

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European Union:
ECJ rules on VAT exemption for financial services

The European Court of Justice (ECJ) ruled on 10 March 2011 that fees for underwriting share issues are exempt from VAT (*Skandinaviska Enskilda Banken AB Momsgrupp v. Skatteverket*).

Underwriting services are services that involve a credit institution providing, for consideration, a guarantee to a company that is about to issue shares, where under the guarantee the credit institution undertakes to acquire any shares that are not subscribed within the period for share subscription. The EU VAT Directive provides for a VAT exemption on financial services, but does not specifically mention underwriting services.

The case concerned a Swedish bank that provided an underwriting guarantee to a company that issued new shares. The bank agreed to guarantee the take up of the offer by purchasing any surplus shares in return for a fee. The bank considered the guarantee as an exempt supply, but the Swedish tax authorities argued that the supply (and fee) was outside the scope of the exemption and, hence, was subject to VAT.

The ECJ held that article 135(1)(f) of Council Directive 2006/112/EC must be interpreted as meaning that the exemption from VAT covers services supplied by a credit institution, for consideration, in the form of an underwriting guarantee to a company wishing to issue shares, where under that guarantee the credit institution undertakes to acquire any shares that are not subscribed within the period for share subscription.

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France:
Due dates for VAT reporting harmonized

New rules in France standardize the due dates for filing a VAT return by an EU-established taxpayer.

Before 1 February 2011, a distinction was made between EU established taxpayers that had appointed a fiscal representative before 1 January 2002 (the date the fiscal representative requirement was abolished) and those that had registered after that date. (It still is possible for such a nonresident to appoint a third party to fulfill VAT compliance obligations on its behalf (e.g. filing the VAT return, making payment, conducting correspondence with the VAT authorities, etc.), but this is not a real fiscal representation and the foreign taxpayer's VAT liabilities will not be shifted to the third party.) Based on the above distinction, different due dates for filing the VAT return applied, with different tax offices competent to accept the return.

Now the same VAT reporting rules apply to all foreign taxpayers established in another EU Member State, regardless of whether a fiscal representative was appointed before 1 January 2002. Such taxpayers must file their VAT returns with the tax office responsible for foreign taxpayers by the 19th day of the month following the tax period. As an exception, EU-established foreign taxpayers engaged exclusively in the VATable renting out of immovable property located in France, and for which the foreign taxpayer is liable for VAT, must file their returns with the tax office where the real property is located by the 24th day of the month following the tax period.

Even though, from a practical perspective, VAT liability is, in most cases, shifted to the taxable recipient under the reverse charge mechanism, VAT returns relating to February 2011 and thereafter must be filed under the new rules.

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Germany:
Dual resident EU/EEA company permitted to form tax group with German parent

In official guidance published on 28 March 2011, the German Ministry of Finance (BMF) advised the local tax offices in Germany to allow the formation of a tax group (Organschaft) between a German parent company (or a foreign parent with a German registered branch) and its subsidiary established in an EU/EEA Member State whose place of management and control is in Germany. The guidance is in response to an infringement procedure initiated by the European Commission against Germany with respect to the requirements for forming a tax group. Currently, it is necessary for the subsidiary company of the group to have both its registered seat and its place of management and control in Germany. The Commission considers the dual residence requirement discriminatory with respect to dual resident subsidiaries that are treated as resident taxpayers in Germany (see the Commission's press release of 30 September 2010, IP/10/1253).

According to the BMF guidance, such a dual resident company must be allowed to be a subsidiary of an Organschaft with its income taxable in Germany if "the additional requirements for forming an Organschaft are met." It is doubtful that Germany has fully implemented the changes requested by the Commission because it still seems to be necessary that the head of the group and the subsidiary conclude a profit and loss pooling agreement (PLPA), at least with respect to the German-source income of the dual resident subsidiary. Since the legal systems of most other EU/EEA Member States do not have the concept of a PLPA, it is unlikely that such a PLPA could be validly concluded. It remains to be seen whether the German BMF will waive the PLPA requirement. Meanwhile, affected taxpayers intending to form a tax group should conclude a PLPA, even if it cannot be registered in the foreign commercial registry.

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Korea:
Bank levy introduced

In an effort to stem excessive capital flows that could destabilize the financial system, the Korean government introduced a Foreign Exchange Stability Levy under the Foreign Exchange Transactions Law that will be imposed on non-deposit foreign currency liabilities within the range of 0.5%.

After the levy was passed by the National Assembly on 5 April 2011, the Ministry of Strategy and Finance (MOSF) issued a proposed revision to the FETL-Presidential Decree, which was officially published on 30 April. The revised FETL provides that all local banks, local branches of foreign banks and state-run banks and institutions, such as the Korea Development Bank, Export-Import Bank of Korea and Industrial Bank of Korea and Korea Finance Corp., are subject to the Foreign Exchange Stability Levy.

To reduce banks' dependence on short-term borrowings for market stability, the MOSF set a four-tiered system by applying lower rates for longer-term debt as follows:

<table>
<tr><th>Maturity</th><th>Basic levy rate</th><th>Additional levy in event of financial crisis</th></tr>
<tr><td>Short-term (within 1 year)</td><td>0.2% (20bp)</td><td rowspan="4">(basic) levy rate + additional levy rate≤1%(100bp)</td></tr>
<tr><td>Mid-term (1-3 years)</td><td>0.1% (10bp)</td></tr>
<tr><td>Long-term (over 3 years)</td><td>0.05% (5bp)</td></tr>
<tr><td>Long-term (over 5 years)</td><td>0.02%(2bp)</td></tr>
</table>

A reduced rate at 50% of the above basic levy rates will be applied to regional domestic banks located outside the metropolitan area.

The MOSF will assess and issue a payment notice for the levy within four months from the end of the fiscal year. The subject financial institutions must pay the bank levy within five months from the fiscal year-end. Companies experiencing financial difficulties can make a request to the MOSF to pay the bank levy in two installments. Penalties will apply for failure to comply with the deadlines: 3% for a one month delinquency and an additional 1% for each month after the first month (up to 10%).

According to the MOSF's announcement, the levy may be collected in U.S. dollars and accumulated in the separate account of the existing Exchange Equalization Fund. The fund accumulated from the levy may be used to provide foreign currency liquidity to distressed financial institutions in the event of future crises.

The MOSF will be issuing a notice that sets out items that will be excluded from the non-deposit foreign currency liabilities subject to the bank levy. Based on previous discussions, foreign currency-denominated deposits, unpaid spot exchanges, losses on the valuation of derivatives and borrowings for sub-loans that are used temporarily in foreign currency transactions may be excluded.

The effective date for the amended rules is 1 August 2011, although the Presidential Decree for the levy is currently in the public hearing process.

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In brief

European Union – The European Court of Justice (ECJ) has upheld a French real property tax that exempts companies having their effective management either in France or in an EU Member State from the tax, but requires those situated in a non-Member State to pay (subject to exemption under a tax treaty or convention on administrative assistance to combat evasion). Prunus, a French-resident company, owned immovable property in France. Its shares were held by a Luxembourg company, the shares of which were owned by two companies resident in the British Virgin Islands, an Overseas Territory. While the ECJ ruled that the French legislation breached the free movement of capital principle (by which an Overseas Territory was entitled to benefit as a non-Member State), the restriction had existed at 31 December 1993 and there was protected by the standstill provision.

OECD – Tax treaties often refer to a "beneficial owner," which in many jurisdictions is a term of art. The OECD has produced a draft amendment to the Commentary to the model treaty to clarify the meaning of the term in the model as being the person entitled to the money.

Thailand – The Revenue Department has announced that, where a services project is carried out partly in Thailand and partly overseas, the 0% VAT rate applies to the portion of the services used by the recipient entirely overseas.

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