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Tax Bulletin
Sourcing of Trading Income: Diverging Trends

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Sourcing of Trading Income: Diverging Trends

Two court decisions in Hong Kong have raised some interesting questions about Singapore's approach to where income is sourced.

In *ING Baring Securities (Hong Kong) Limited v Commission of Inland Revenue*[1], the company's (ING HK) principal business was to act as an agent in securities dealing and the issue was whether the three types of income, namely, commission income, placement income and marketing income, earned by ING HK from securities traded on stock exchanges outside Hong Kong, was sourced in Hong Kong.

Commission income: Orders for the Asian market would be referred to ING HK by its related entities who are approached by a client in their respective countries. ING HK would instruct a broker in the country where the order had to be transacted through the stock exchange in that country. Out of the fee received from the client, ING HK would pay the expenses incurred on the transaction, including the broker's commission and it would retain the net commission.

Placement income: ING HK would take orders for new issues from its clients, in Hong Kong and elsewhere, and pass them to its related parties located in the country where the shares were being issued. Placement income was earned for the successful placement of the issue.

Marketing income: This referred to fees received by ING HK for referring clients to another entity within the group where the introduction resulted in a transaction concluded for the client.

In the course of his judgment, Lord Millett went through a number of cases to distil the broad guiding principles to be applied in determining the geographical source of a taxpayer's profits. In summary:

- the place where the taxpayer's profits arise was not necessarily the place where he carried on business;
- where a commission was earned for a service performed, the profit was earned where the service was rendered and not where the contract for commission was entered into;
- the transactions must be looked at separately and the profits of each transaction considered individually; and
- where the taxpayer engaged others to act for him in executing a transaction for a client, his profit was earned where the transaction was carried out whether the persons engaged did so as agents or principals.

The Court of Final Appeal held that none of the three types of income arose in Hong Kong. Commission income was derived from transactions that took place on stock exchanges outside Hong Kong. Similarly, placement income was earned at the place where the shares were subscribed for, which was outside Hong Kong. As for marketing income, this was earned where the introduction was made. This was the place where the party to whom the introduction was made was located – an introduction was of no value until it was received.

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[1] FACV 19/2006

To the Court of Final Appeal, all work done before the actual execution on the stock exchange was irrelevant in determining the locality of profits. That ING HK took instructions from its client and cabled those instructions to the overseas brokers was inconsequential. These were not services ING HK was engaged to perform, but the means by which the services were performed. Also, it was found that the fact that the actual execution was done by an agent (ie the broker) was irrelevant. While Barings group's research work and the efforts of its employees in maintaining relationships with clients were of commercial importance to Barings' business, the court did not consider them to be services which the clients paid for.[2]

In *Commissioner of Inland Revenue v Li & Fung (Trading) Limited,*[3] the taxpayer company (LFT) managed its clients' supply chain by locating suppliers, arranging for manufacturers and monitoring production schedules as well as taking care of quality control, shipment and settling merchandise claims on their behalf. The agency agreements were entered into in Hong Kong but the actual services were often performed outside Hong Kong. It normally charged its clients a commission of 6% of the total FOB value of the client's export sales but paid 4% to its affiliates for the services they perform outside Hong Kong.

The Commissioner sought to assess the 2% (6% less 4%) to profits tax on the basis that LFT had earned the 2% for managing its own activities and those of its affiliates from its Hong Kong headquarters. The argument was that LFT's profits could not have been generated through the activities of LFT's overseas affiliates alone. Management and supervision performed by LFT in Hong Kong contributed towards profits generation too.

Reyes J rejected the above contention. Applying *ING Baring*, he held that the Board was correct in arriving at the conclusion that the 2% was earned offshore. The 6% gross commission was generated by sourcing and agency activities carried out by LFT affiliates offshore. These affiliates assisted LFT's customers in placing orders with offshore sellers, supervising the manufacturer, arranging for the shipment of goods and ensuring the delivery of goods to LFT's customers. These were the activities that gave rise to the 6% commission, without which, no commission could have been earned. Reyes J thought the arguments put forward by the Commissioner was precisely the "brain analogy" that had been rejected by the Court of Final Appeal in *ING Baring*.

The Singapore scene

The crux of these cases seem to focus on the final phase of the transactions without which the income would not have been earned, and if that took place outside Hong Kong, then the income was sourced outside Hong Kong.

Do the Inland Revenue Authority of Singapore (IRAS) adopt this approach? Could it not be similarly argued that in the same way that the income cannot be earned until the final phase of transaction is concluded, it is equally true to say that without the earlier phases, there can be no final phase? Can it not be said that the earlier phases are different activities which warrant some attribution of the profit earned in the whole process? In this context, some guidance can be gleaned from the OECD's (Organisation of Economic Co-operation and Development) pronouncements around this subject.

The *OECD Model Tax Convention of Income and Capital* and the *OECD Transfer Pricing Guidelines* are heavily laced with transfer pricing principles which basically require transactions between related parties to be at arm's length. This means that they are to transact with each other as if they were not related as that would determine what they would charge an unrelated party for the same services.

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[2] *ING Baring*, para 160
[3] HCIA 1/2010

The issue about transfer pricing is about being properly remunerated for the value of the services and if one were to follow this principle through, then it would not be unreasonable to assume that the courts in deciding the cases discussed were not questioning the proper remuneration but ruled that that share of the remuneration was not taxable in Hong Kong because it depended on the final phase of the transaction to be concluded.

The IRAS applies the operations test in determining the question of where trade or business income is sourced, which is evident from its *Income Tax Guide on E-commerce*.[4] The whole gamut of activities including sales and research, taking instructions from clients, relaying the same to foreign brokers, etc, would form part of the operations giving rise to the income. Similarly, the management and supervision of the overall procurement service provided at a Singapore headquarters is likely to count towards the essence of the operations that gives rise to Singapore-sourced income. This is notwithstanding that the actual transactions giving rise to profits may be performed outside Singapore by a sub-contractor. Thus, it would be surprising if the IRAS follows the decisions of the courts in the cases discussed.

This approach of the IRAS seems consistent with the OECD's concept of "significant people functions" in the context of profit attribution between a head office and its permanent establishment (PE). The authorised OECD approach in attributing profits to a PE requires a factual and functional analysis by identifying the significant people functions – or KERT (Key Entrepreneurial Risk Taking) for financial services enterprises – performed by the PE. The identification of significant people functions thus allows risks and assets to be attributed to the PE. The pertinent point is that assets and risks will be attributed according to where the main decision-making over those assets and risks is located, much like how the IRAS interprets how the operations test works.

The key question beyond the IRAS's reaction is what the Singapore courts will decide if a taxpayer takes this to them. While no one can anticipate which way they will go, when planning, it is important to ensure that the arrangements take sourcing, treaty implications as well as transfer pricing principles into account. In short, the overall outcome should be coherent. For multinationals, it is pertinent that the tax profiles of the group entities are consistent: losing sight of the potential foreign tax exposure while trying one's best to keep income received in Singapore classified as foreign-sourced may come back and bite them later.

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[4] Published on 23 February 2001. See para 2.1.3 of the circular.

Get in touch

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