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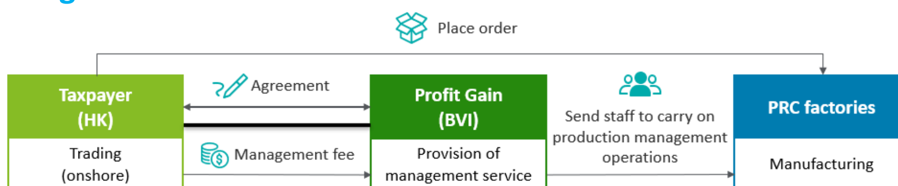
Hong Kong Tax Analysis

Court of First Instance ruled management fees paid to a related interposed management service agent not deductible

Hong Kong's Court of First Instance (CFI) recently released its decision on *Chapman Development Limited v. Commissioner of Inland Revenue* [2024 HKCFI 2590]. The CFI upheld the Board of Review (BoR)'s decision [*D11/22*] and ruled that management fees paid to a related interposed management service agent for the provision of production management services were not deductible on the grounds that (1) the taxpayer failed to provide satisfactory evidence to prove that the portion of fee not paid in accordance with the written agreement was incurred in the production of assessable profits; and (2) the transaction constituted a tax avoidance arrangement under Section 61A of the Inland Revenue Ordinance (IRO).

In this article, we summarize the facts of the case and highlight the BoR's and the CFI's rationale for denying the deductibility of management fees.

Background



- The taxpayer was incorporated in Hong Kong in 1991 and engaged in manufacturing and trading of fabric and yarn and provision of trade-related services.
- It took orders for fabrics and placed them with its related Mainland China entities' factories (PRC Factories) or third-party manufacturers for production.
- The taxpayer appointed a newly set up BVI associated company, Profit Gain, as its management agent for fabric production with effect from 1996 under a management agreement dated 1997.
- Profit Gain's staff carried out the production management operations for the taxpayer in Mainland China.

Authors:

Doris Chik
Tax Partner
Tel: +852 2852 6608
Email: dchik@deloitte.com.hk

Carmen Cheung
Senior Tax Manager
Tel: +852 2740 8660
Email: carmcheung@deloitte.com.hk

Kiwi Fung
Tax Manager
Tel: +852 2258 6162
Email: kifung@deloitte.com.hk

For more information, please contact:

Tax & Business Advisory
Southern Region Leader
Jennifer Zhang
Tax Partner
Tel: +86 20 2885 8608
Email: jenzhang@deloitte.com.cn

Southern Region Deputy Leader
Raymond Tang
Tax Partner
Tel: +852 2852 6661
Email: raytang@deloitte.com.hk

- According to the management agreement, the taxpayer would pay a management fee to Profit Gain based on the weight of the fabrics or any other rate as may be mutually agreed upon by the parties.

The taxpayer claimed the management fees paid to Profit Gain as deductible in the profits tax returns. However, the Inland Revenue Department (IRD) disallowed the portion of management fees which were not paid in accordance with the written terms of the management agreement (Extraneous Fees) on the grounds that they were not incurred in the production of assessable profits under Section 16 of the IRO. Regarding the portion of management fees paid in accordance with the written agreement (Management Fees), although they were considered deductible under Section 16 of the IRO, the IRD was of the view that the management arrangement was a transaction carried out for the sole or dominant purpose of obtaining a tax benefit. Thus, the Management Fees were disallowed to counteract the tax benefit under Section 61A of the IRO.

Dispute

The two key issues in dispute were:

Issue 1 – Whether the Extraneous Fees were deductible under Section 16 of the IRO.

Issue 2 – Whether the management arrangement was for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit within the meaning of Section 61A of the IRO.

Decision

Both the BoR and CFI ruled in favour of the IRD, concluding that the management fees were not deductible. The taxpayer's arguments and the reasoning provided by the BoR and the CFI are summarized below.

Issue 1: Whether Extraneous Fees were deductible under Section 16

The taxpayer contended that the Extraneous Fees were payable by an agreement established through conduct. It argued that a contract could be inferred by conduct by applying an objective test, even when nothing was said or written. In support of this claim, debit notes were provided as evidence to prove that the amounts were actually charged to the taxpayer.

However, both the BoR and CFI considered the taxpayer's evidence insufficient to support the claim that the rates of the fees in the management agreement had been varied by the conduct. Specifically, they noted the followings:

- The taxpayer chose not to call a witness with direct knowledge of the matter. Instead, the taxpayer's witness, who once described the fee as a "bonus" and said that it was not a "management fee", did not have direct personal knowledge of the management arrangement but only learned the operations through monthly meetings of the Executive Committee of the Group.

- The taxpayer presented different versions of evidence regarding the nature of the fees and the basis of rates that deviated from the written agreement. It initially claimed that there was an oral agreement on the variation of management fee but later changed the argument to variation by conduct.

- The taxpayer attempted to prove its case through bare assertions (i.e. claims without supporting evidence). It failed to discharge the burden of proof in support of the existence of other agreements to vary the written terms of the management agreement.

Given the unsatisfactory nature of the evidence, the BoR and the CFI concluded that the Extraneous Fees were not incurred in the production of assessable profits and hence not deductible under Section 16 of the IRO.

Issue 2: Whether the arrangement was for the sole or dominant purpose of obtaining a tax benefit

The taxpayer argued that it was legitimate to use a separate bona fide entity to segregate functions performed outside Hong Kong from those performed in Hong Kong and therefore the arrangement could not be attacked by the general anti-avoidance provision Section 61A. While the BoR agreed that Profit Gain was not a mere sham, it rejected the taxpayer's argument that it was a legitimate arrangement because it was tainted by the fact that Profit Gain did not register its business in Mainland China, which contravened the laws and regulations. In addition, both the BoR and CFI considered that a transaction that serves a commercial purpose can nevertheless be caught by Section 61A.

The analysis then turned to the alternative hypothesis that if Profit Gain had not been interposed, the taxpayer would have carried out the production management work with its own staff in Mainland China. The taxpayer asserted that under this hypothesis, the profits attributable to the work in Mainland China should be offshore-sourced and not taxable. Hence, no tax benefit was obtained from the management arrangement. The BoR and the CFI, however, considered under the alternative hypothesis, no management fees would be paid to Profit Gain, and no additional profit would be earned by the taxpayer. They considered the production management work done in Mainland China to be antecedent activities that would not lead to any offshore trading profits. They concluded that the management arrangement could result in a tax benefit by allowing the taxpayer to claim a deduction of expenses and lower its tax liability.

The CFI further reiterated that the approach under Section 61A of the IRO is an objective one, taking into consideration the matters listed therein. The BoR had considered the seven matters[1] under Sections 61A(1)(a) to (g) of the IRO in drawing the conclusion that the management arrangement was for a sole or dominant purpose of obtaining a tax benefit. The factors leading to such conclusion include:

- The management agreement stated on its face that it was to have effect from a date before Profit Gain existed.
- The parties did not follow the terms of the management agreement.
- Profit Gain's staff previously worked for the taxpayer or other group companies.
- Profit Gain's staff represented themselves as representatives of the PRC Factories and their name cards only bore the name of the PRC Factories.
- Profit Gain did not file individual income tax returns for its staff.
- The transaction was not entered into on an arm's length basis. The taxpayer placed heavy reliance on the "assumption of risk" to justify the high profit margin of Profit Gain. The BoR did not accept because all the business was from group companies and there was unlikely real risk of claims.

Our observations

This case highlights that even management fees are paid to a related interposed management service agent with real operations (not a “sham” or “bookkeeping entity”), they may still be subject to scrutiny if the transaction constitutes a tax avoidance arrangement under Section 61A of the IRO. Specifically, a transaction that serves a proper commercial purpose can still be caught by Section 61A if its sole or dominant purpose is to confer a tax benefit. It depends on the facts of each case, and there are several unfavourable factors that contributed to the failure of this taxpayer’s case.

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[1] Seven matters under Sections 61A(1)(a) to (g) in deciding the sole or dominant purpose of the transaction: (1) the manner in which the transaction was entered into or carried out (2) the form and substance of the transaction (3) the result that would have been achieved by the transaction (4) any change in the financial position of the taxpayer as a result of the transaction (5) any change in the financial position of any connected person (6) whether the transaction has created rights and obligations which would not normally be created between persons dealing with each other at arm's length (7) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong

It is crucial that payments are made in accordance with the written provisions of an agreement. Any variations to the terms of the agreement should be well-documented, as taxpayers bear the burden of proof. Bare assertions not supported by contemporaneous documents would not be accepted as evidence, especially when there are differing versions of assertions.

As of the date of this publication, it is not yet known whether the taxpayer will appeal to a higher level of court. Taxpayers that engage related parties to provide services should monitor developments and seek professional advice in assessing the deductibility of service fees in their cases. In particular, taxpayers with similar arrangements should be mindful about the potential exposure of the general anti-avoidance provision notwithstanding that the arrangements may serve a commercial purpose.

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Country Leader of Tax and Business Advisory services, Deloitte China
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloittecn.com.cn

Northern China
Xiaoli Huang
Partner
Tel: +86 10 8520 7707
Fax: +86 10 6508 8781
Email: xiaolihuang@deloittecn.com.cn

Eastern China
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloittecn.com.cn

Southern China
Jennifer Zhang
Partner
Tel: +86 20 2885 8608
Fax: +86 20 3888 0115
Email: jenzhang@deloittecn.com.cn

Western China
Frank Tang
Partner
Tel: +86 23 8823 1208
Fax: +86 23 8857 0978
Email: ftang@deloittecn.com.cn

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National Leader/Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 6508 8781
Email: juliezhang@deloittecn.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloittecn.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloittecn.com.cn

Southern China (Mainland)
Tony Yao
Partner
Tel: +86 755 3353 8103
Fax: +86 755 8246 3222
Email: heyao@deloittecn.com.cn

Southern China (Hong Kong)
Doris Chik
Partner
Tel: +852 2852 6608
Fax: +852 2543 4647
Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify national marketing team of Deloitte China by email at cimchina@deloitte.com.hk.

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