Hong Kong (SAR) Tax Alert

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The court held management fees paid to a BVI group company are not deductible

Summary

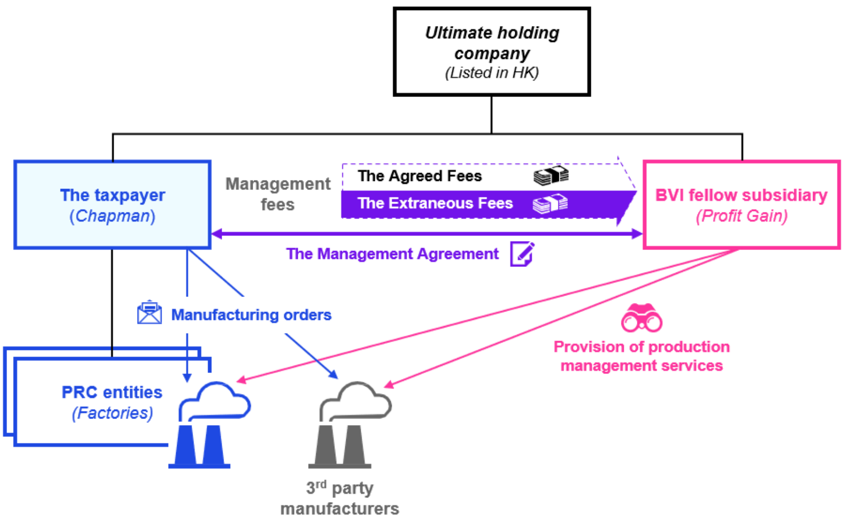
The Court of First Instance (CFI) recently held in a case that the management fees paid by a Hong Kong SAR company to its related company in the BVI are not deductible. The portion of the management fees paid in accordance with the contractual terms of a management agreement (the Agreed Fees) was held as non-deductible under the general anti-avoidance rule whereas the portion paid in excess of what was agreed (the Extraneous Fees) was held as non-deductible under the general expense deduction rule.

In this news alert, we summarise the court's analysis and share our observations from the case.

The CFI handed down its judgment in *Chapman Development Limited v Commissioner of Inland Revenue*[1] on 30 September 2024. The CFI upheld the Board of Review's decision[2] and dismissed the taxpayer's appeal.

Background

The diagram below set out the relevant facts of the case.



Other relevant facts:

- The taxpayer was a Hong Kong incorporated company and its principal activity was manufacturing and trading of fabric and yarn and the provision of trade related services.
- The taxpayer and Profit Gain shared common shareholders, directors and a correspondence address at all material times
- Profit Gain had employees in Mainland China to perform the production management services
- Profit Gain did not register its business in Mainland China

Note: This is a simplified group chart showing the relationships between the key parties in the case only

1 The CFI judgment can be accessed via this link to the Judiciary website: https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=163048&currpage=T
2 The relevant Board of Review decision (i.e. Case D11/22) can be accessed via this link: https://www.info.gov.hk/bor/en/decisions/D1122.pdf

The issues in dispute

The issues in dispute in this case are:

(1) whether the Extraneous Fees were expenses incurred in the production of the taxpayer's assessable profits and therefore deductible under the general expense deduction rule (i.e. section 16(1) of the Inland Revenue Ordinance (IRO)); and

(2) whether the general anti-avoidance rule (i.e. section 61A of the IRO) was applicable to the arrangement of the Agreed Fees[3].

The CFI's judgment and analysis

Below is a summary of the CFI's judgment and analysis:

Issue 1: Whether the Extraneous Fees are expenses incurred in the production of the taxpayer's assessable profits?

- There were various types of Extraneous Fees which were not calculated according to the written terms of the Management Agreement. In this regard, the taxpayer firstly claimed that there was an oral agreement to vary the terms of the Management Agreement and then shifted its case to claim that there was a variation agreement by conduct.
- The CFI noted that the Board did accept that the taxpayer could vary the terms of the Management Agreement either orally or by conduct (without imposing a requirement that variation by conduct could only be established by evidence of verbal exchanges). However, the taxpayer failed to prove such variation of terms as the evidence put forward by the taxpayer's witness was unsatisfactory.
- The taxpayer's evidence was unsatisfactory as: (1) different versions of evidence on the nature of the Extraneous Fees and the basis for agreeing on the varied charging rates of the fees were presented (e.g. the taxpayer's witness described the amount as bonus and said it was not a management fee), (2) the taxpayer chose not to call witness with direct knowledge of the matter and (3) the taxpayer attempted to rely on bare assertions or unparticularised multiple hearsay to prove the alleged variation of the terms of the Management Agreement.
- Based on the above, the CFI held that the Extraneous Fees were not incurred in the production of the taxpayer's assessable profits (as its nature cannot be ascertained) and therefore not deductible under section 16(1) of the IRO.

Issue 2: Whether section 61A was applicable to the arrangement of the Agreed Fees?

- There was no dispute that the Agreed Fees were deductible under section 16(1) of the IRO.
- Section 61A empowers the Inland Revenue Department (IRD) to disregard or counteract a transaction if the following three intersecting conditions are satisfied: (1) a transaction has been entered into; (2) the transaction has, or would have had, the effect of conferring a tax benefit on a person and (3) having regard to the seven factors set out in section 61A, the sole or dominant purpose of entering into the transaction is to obtain a tax benefit.
- Regarding condition (1), there was no dispute that "the entering into of the Management Agreement and each payment made thereunder" was the transaction giving rise to a tax benefit.
- Regarding condition (2), the alternative hypothesis that was accepted by the Board and not challenged by the taxpayer was: the taxpayer would have performed the production management work itself had Profit Gain not been used.
- The Board found that comparing the transaction with the alternative hypothesis, there was a tax benefit for the taxpayer as its tax liability was reduced by a deduction of the Impugned Management Fees.
- On the other hand, the taxpayer argued that under the alternative hypothesis, it would have earned additional profits attributable to Profit Gain's performance of production management work in Mainland China, and such profits would be offshore-sourced and not taxable.

[3] The IRD applied section 61A and disallowed the portion of the Agreed Fees that represented the operating profits of Profit Gain (the Impugned Management Fees).

- The CFI rejected the taxpayer's argument and held that under the alternative hypothesis, no party would have paid the taxpayer for the production management work and the taxpayer would not have earned any additional profits by taking over Profit Gain's business operation. Instead, the taxpayer would not have paid the Agreed Fees to Profit Gain. As such, the transaction had the effect of conferring a tax benefit on the taxpayer within the meaning of section 61A.
- The CFI also noted that the IRD's assessment under challenge was based on disallowance of the deduction of the Impugned Management Fees rather than on any additional income the taxpayer would have earned under the alternative hypothesis.
- For condition (3), the taxpayer argued that in concluding that the transaction was carried out for the sole or dominant purpose of enabling it to obtain a tax benefit, the Board took into account irrelevant factors (e.g. Profit Gain had not registered its business in Mainland China) and omitted the relevant ones (e.g. the arrangement between the taxpayer and Profit Gain was not a sham, real operations were carried out by Profit Gain in Mainland China using its own staff, and the Agreed Fees were not arbitrary or excessive in return for the real services performed by Profit Gain).
- The CFI did not agree (e.g. application of section 61A is not constrained to transactions that is a "sham" and a fee that is not arbitrary or excessive can nevertheless be paid for the sole or dominant purpose of getting a tax benefit). It held that as the Board's conclusion that the transaction was entered into for the sole or dominant purpose for obtaining a tax benefit was not contrary to the only true and reasonable one, it is not permissible for the court to re-weigh the evidence or place more weight on matters that were favorable to the taxpayer to arrive at a different conclusion from the Board.
- Based on the above, the CFI held that section 61A was applicable and the Impugned Management Fees should be disallowed.

KPMG Observations

We set out below a few observations from the case:

- Intra-group management fee arrangements, especially those involving a BVI company, continue to be one of the areas subject to the close scrutiny of the IRD.
- This case highlights the importance of maintaining sufficient documentation and/or producing reliable witness evidence in handling tax disputes, given the burden of proof lies with taxpayers.
- In terms of applying section 61A, a transaction that serves a commercial purpose or a payment that is made on an arm's length basis can nevertheless be caught by section 61A if the sole or dominant purpose of the transaction or payment is to obtain a tax benefit.

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