Hong Kong Tax Alert

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Court denies deductions for management fees paid under the general anti-avoidance provisions of section 61A

The Court of First Instance (CFI) recently upheld the decision of the Board of Review (BOR) that an arrangement undertaken by a trading company (the Taxpayer) was a transaction entered into for the sole or dominant purpose of obtaining a tax benefit under section 61A of the Inland Revenue Ordinance (IRO)[1].

The arrangement involved the Taxpayer segregating its previous function of managing the production processes at factories in mainland China in respect of orders it placed with them into a separate offshore group company. Thus, the management fees paid by the Taxpayer to the offshore company, found to be deductible under section 16 of the IRO, were nevertheless disallowed.

This alert discusses how the BOR and the CFI approached the issues involved in their consideration of the application of the provisions of section 61A to the facts of the case.

Clients who have any questions on the potential application of section 61A to a transaction that they have entered into can contact their tax executives.

[1] The full CFI judgement could be accessed in the link below:

https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=163048&QS=%24%28chapman%29&TP=JU

Background

The Taxpayer was a member of a group of companies (the Group) and its ultimate holding company was listed on the Stock Exchange of Hong Kong (Listco) in 1996. Listco and its subsidiaries were engaged in the retailing, export and production of casual wear.

At the material times, the Taxpayer's principal activity was the manufacturing and trading of fabric and yarn and the provision of trade related services. The Taxpayer held majority shareholding interests in two mainland entities (the PRC Factories[2]), which were the manufacturing arm of the Taxpayer. The Taxpayer itself was not a manufacturing company.

The Taxpayer took orders for fabrics and placed them with the PRC Factories or third-party manufacturers.

By way of a management agreement dated 1 April 1997 (the Management Agreement), the Taxpayer appointed Profit Gain Trading (BVI) Limited (Profit Gain), as its management agent for "knitted and dyed fabric production to be required in China factories", with retrospective effect from 1 April 1996. The China factories refer to the PRC Factories and other third-party manufacturers.

Under the Management Agreement, the services provided by Profit Gain were essentially managing, supervising and providing technical support to the manufacturing processes at the China factories , and ensuring the quality control and providing inspection services for the fabric produced at the China factories.

The Management Agreement provided that the fees charged were to be calculated based on certain specified rates per pounds for dyed or knitted fabrics produced or any other rate as may be mutually agreed upon by the two parties.

Commissioner's determination disallowing the substantial management fees paid

The Taxpayer claimed tax deductions for management fees paid to Profit Gain for the years of assessment 1997/98 to 2004/05 (the Management Fees), aggregating in total to the tune of several hundred of million.

In February 2004, a tax audit was commenced in relation to the Taxpayer's tax affairs. After the tax audit, the Assistant Commissioner considered that part of the Management Fees claimed by the Taxpayer were not deductible under sections 16 and 17 of the IRO. The Assistant Commissioner was also of the view that the appointment of Profit Gain as the production management agent of the Taxpayer was a transaction carried out with the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit, and the general anti-avoidance provisions contained in section 61A of the IRO should apply. The deduction of the Management Fees (save to the extent of the bank charges and administrative or operating expenses incurred by Profit Gain) (the Impugned Management Fees) were thus disallowed.

Dissatisfied with the Commissioner's determination on the disallowance of the Impugned Management Fees, the Taxpayer appealed to the BOR.

Appeal against the Commissioner's determination to the BOR

An important feature of the case was that the sums claimed by the Taxpayer for deductions were not all calculated based on the specified rates as stated in the Management Agreement but on some other higher rates. Furthermore, the fees charged also covered services for dyed thread which the Management Agreement had made no provision for.

The BOR held that:

(i) the Management Fees which were not paid in accordance with the written terms of the Management Agreement (which the BOR termed the "Extraneous Fees") were not expenses incurred in the production of the Taxpayer's assessable profits, and therefore not deductible under sections 16 and 17 of the IRO;

(ii) the Management Fees paid in accordance with the written terms of the Management Agreement (which the BOR termed the "Management Fees Per Written Agreement") were deductible under sections 16 and 17 of the IRO; and

(iii) however, "the entering into the Management Agreement pursuant to which the Taxpayer paid the Management Fees Per Written Agreement as well as each and every payment made thereunder (the Transaction) was a transaction entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit within the meaning of section 61A of the IRO.

Thus, the BOR dismissed the Taxpayer's appeal. Dissatisfied, the Taxpayer appealed to the CFI against the BOR's decision.

[2] Paragraph 6 of the CFI judgement refers.

CFI decision

Extraneous Fees

The judge considered that, based on the unsatisfactory evidence given by the witness, the BOR was justified to hold that the Taxpayer failed to discharge its burden of proof that the terms of the Management Agreement had not been varied either by oral agreement between the two parties or by the conduct of both parties.

Thus, the CFI upheld the BOR's decision on the issue.

Applicability of section 61A

Argument that the Transaction had conferred no tax benefit on the Taxpayer

The Taxpayer argued that the Management Fees Per Written Agreement were attributable to tasks performed by Profit Gain in mainland China, so that any profits attributable to the business carried out by Profit Gain were sourced outside Hong Kong.

Thus, even if the Transaction was disregarded and whole arrangement was reconstructed under section 61A of the IRO as if the Taxpayer had not appointed Profit Gain and itself performed the production management function at the China factories (the Alternative Hypothesis), the Taxpayer contended that the profits derived by it from performing such function would be sourced outside Hong Kong and not chargeable to tax in Hong Kong. As such, the Transaction had conferred no tax benefit on the Taxpayer.

The judge however considered that this argument is fundamentally flawed because "[u]nder the Alternative Hypothesis, nobody would have paid the Taxpayer for the mainland operations carried out by Profit Gain. The Taxpayer would not have earned additional profits for carrying out such operations. The Taxpayer would have earn[ed] the same income under the Alternative Hypothesis and the Transaction, that is, the receipts from its trading operations. The difference between the Transaction and the Alternative Hypothesis is that under the Transaction, the Taxpayer paid away a part of its profits to Profit Gain in the form of Management Fees. Under the Alternative Hypothesis, the Taxpayer would be able to retain the Impugned Management Fees for itself. The Taxpayer therefore enjoyed a tax benefit under the Transaction of claiming the Impugned Management Fees as deductions under s.16 IRO."

The judge also noted that (i) whether the activities carried out by Profit Gain would have been profit-producing for Profit Gain or resulted in offshore income for Profit Gain does not shed light on whether those activities, if carried out by the Taxpayer would have been the source of profit for the Taxpayer; and (ii) the BOR found no convincing evidence that if the Taxpayer were to take over Profit Gain's role, its trading income would be offshore.

Thus, the Taxpayer's appeal on this ground was dismissed.

Argument that the BOR took into account irrelevant factors and left out relevant ones in coming to its conclusion that the sole or dominant purpose of the Transaction was to obtain a tax benefit

The judge first noted that the captioned complaint of the Taxpayer is not a ground for appellate intervention unless it can be said that it led the BOR so far astray as to reach a conclusion contrary to the true and only reasonable one. It is not the Court's task to simply re-weigh the evidence to arrive at its own conclusion.

After making the above general observation, the judge then considered the following specific matters complained about by the Taxpayer:

Legitimacy for the Group to separate its Hong Kong-based operations from its offshore operations

The crux of this complaint was that where it is legitimate to use a separate bona fide entity to segregate functions performed outside Hong Kong, and the fees charged are not found to be arbitrary or excessive in return for real services performed, it would be perverse, without taking these matters into account, to conclude that the sole or dominant purpose of the transactions entered into was to obtain a tax benefit.

The judge however noted that "... what happened in this case is that the Taxpayer was charged substantial fees, resulting in a profit margin far lower than that of Profit Gain, whilst the overall profits remained within the Group, with the sums siphoned off not being subject to tax. The Taxpayer cannot simply just say that segregation per se is legitimate and brush aside what flowed from it. As Ribero PJ observed in *Ngai Lik*[3] at [99(e)] as regards the factors in s.61A(a) to (g):

> "Paragraph (d) and (e) require us to look at the financial effects of the particular scheme on the taxpayer and also on persons connected with the taxpayer, such as the group to which a taxpayer company belongs. It may be highly significant under para. (d) that the scheme brings about no changes to the taxpayer's financial position while at the same time producing a tax benefit. Or, under para. (e), it may be significant that the scheme involves transactions among group members resulting in an unchanged financial position for the group as a whole but in the conferment of a tax benefit on the taxpayer."

The Transaction was not a sham: there were real employees carrying out real operations in mainland China

The judge noted that "unlike s.61 which catches "artificial" or "fictitious" transactions, with "fictitious" approximating in meaning to "sham" ...s.61A is not so constrained. As the Board observed, a transaction that serves a commercial purpose can nevertheless be caught by s.61A, if the sole or dominant purpose of entering into the transaction was to obtain a tax benefit. Indeed, it may very well be the case that in order for a transaction to produce a tax benefit, it needs to be carried out with staff being engaged and paid".

The Management Fees Per Written Agreement were not arbitrary or excessive

The judge considered that this was a finding relevant to whether these fees were deductible under sections 16 and 17 of the IRO. They had to be deductible before section 61A of the IRO could apply at all. A payment which is properly deductible under sections 16 and 17 of the IRO nevertheless constitutes a tax benefit; if the sole or dominant purpose is to get the benefit, then section 61A applies.

Not unusual for the Taxpayer and Profit Gain, being related parties, not to strictly follow the terms of the Management Agreement

The judge considered that this can only undermine the Taxpayer's case that the Transaction was a commercial decision to restructure its organisation for the segregation of the business functions.

BOR took into account certain factors that were irrelevant

The irrelevant factors which the Taxpayer complained that the BOR should not have taken into account included the following facts:

(i) Profit Gain had not registered its business in mainland China.

(ii) The work of Profit Gain's staff was put, for example, in the name of the PRC Factories, and Profit Gain's staff represented themselves as representatives of the PRC Factories.

(iii) Profit Gain relied on its related companies to pay staff salary when it had not set up its bank account during the initial period after its incorporation.

The judge however considered that these facts were relevant for consideration under paragraph (a) and paragraph (b) of section 61A(1)(a) to (g) referred to above in terms of (a) the manner in which the transaction was entered into or carried out and (b) the form and substance of the transaction.

BOR failed to address the question of whether the Transaction created rights and obligation which would not normally be created between related parties dealing with each other at arm's length under a transaction of the kind in question under paragraph (f) of section 61A(1)(a) to (g)

In this regard, the BOR only held that the Transaction was not entered into on an arm's length basis without considering whether it would be one not normally created between persons dealing with each other at arm's length under a transaction of the kind in question.

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[3] *Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue* (2009) 12 HKCFAR 296

The judge however considered that even on the assumption that the Transaction did not create rights or obligations that are not normally created between persons dealing at arm's length, the Taxpayer does not show how this meant that the BOR's decision was contrary to the only true and reasonable one.

In conclusion, the judge noted that the Taxpayer's arguments amount to no more than inviting the Court to re-weigh the evidence, placing weight on matters favorable to the Taxpayer and discounting those which are not less favorable, so as to arrive at a different conclusion from the BOR. This is not a permissible approach.

Thus, the judge dismissed the Taxpayer's appeal and upheld the BOR's decision.

Commentary

This decision reaffirms the previous decisions held by the Court of Final Appeal that the three intersecting conditions must be satisfied before the power conferred to an Assistant Commissioner under section 61A(2) of the IRO can be exercised. They are:

(i) a transaction (broadly defined to include an operational scheme) has been entered into;

(ii) such transaction, has, or would have had but for section 61A, the effect of conferring a tax benefit on the relevant person (that is, on the taxpayer against whom the section has been invoked); and

(iii) viewing the transaction through the prism of the seven matters enumerated in section 61A(1)(a) to (g) globally, it would objectively be concluded that it was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

In considering whether a transaction has conferred a tax benefit on a taxpayer, section 61A raises a straightforward question of causation and comparison. If the effect of the transaction is that a taxpayer's liability to tax is less than it would have been on some other appropriate hypothesis, e.g., the Alternative Hypothesis adopted in this case, the taxpayer has had a tax benefit. The tax benefit does not have to relate to some other pre-existing source of income, external to the transaction.

Section 61A(2)(b) confers the power to tax the taxpayer "in such other manner as the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained". The hypothesis of an assessment under section 61A(2)(b) must therefore be not only the actual transaction did not take place, but some other transaction took place instead. The Assistant Commissioner can assess the taxpayer on the hypothesis that there was a transaction, but without the features which conferred the tax benefit.

Section 61A can have a wider application than section 61 as it can apply to a transaction with a commercial purpose, i.e. not artificial or fictitious, if it would be objectively concluded that the sole or dominant purpose of the transaction was to obtain a benefit.

As the decision indicates, the analysis and application of the seven matters specified in section 61A(1)(a) to (g) to the facts of a case in a tax tribunal's consideration of whether the sole or dominant purpose of a transaction was to obtain a tax benefit is complicated and fact specific.

Clients who have any questions on the potential application of section 61A to a transaction that they have entered into can contact their tax executives.

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