

Case No. D 11/22

Additional profits tax – management fee paid to the related company – whether the impugned management fees are deductible expenses under sections 16(1) and 17 of the Inland Revenue Ordinance – whether the transactions was for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit so that section 61A is engaged - the Board’s function on hearing an appeal – mere assertions or statements of the tax representatives do not form part of the evidence – evidence put forward by the Taxpayer which was not challenged by the Revenue could not be taken as accepted by the Revenue as the fact – whether adverse inference could be drawn against the taxpayer in the absence of documentary evidence and oral evidence from reliable witness on these pertinent issues – intersecting conditions must be satisfied to raise an assessment under section 61A(2) – whether a transaction that serves a proper commercial purpose can still be caught by section 61A as for the sole and dominant purpose of conferring a tax benefit

Panel: Liu Yuk Ling Elaine (chairman), Law Chung Ming Lewis and Yuen Hoi Ying.

Dates of hearing: 21-22 May 2020 and 26 June 2020.

Date of decision: 28 July 2022.

The Taxpayer is a company incorporated in Hong Kong. The taxpayer’s principal activity was the manufacturing and trading of fabric and yarn and provision of trade related services. Company A was incorporated in the BVI. As at 31 December 2003, the shareholders of Company A was the same as those of the Taxpayers. At all material times, Company A and the Taxpayer had common directors. The ultimate holding company of the Taxpayer and Company A was a Bermuda company named Company H, which was listed on the Stock Exchange of Hong Kong in 1996.

The subject matter of this appeal concerns the management fee (‘Management Fees’) paid by the Taxpayer to its related company, Company A during the relevant years of assessment. The Taxpayer claimed for the deduction of the Management Fees. The Commissioner allowed the deduction of the bank charges and administrative expenses incurred by Company A under sections 16 and 17 of the Inland Revenue Ordinance but disallowed the deduction of the remaining sum (‘Impugned Management Fees’). The Impugned Management Fees were essentially the operating profits of Company A in the relevant years. The Impugned Management Fees made to Company A should be regarded as the profits of the Taxpayer and be assessed on the Taxpayer under section 61A(2)(b) of the Ordinance to counteract the tax benefit which would otherwise be obtained. The assessments for the years of assessment of 2003/04 and 2005/06 as well as the first additional Profits Tax assessment for the year of assessment of 2004/05 were recomputed accordingly. The Taxpayer raised objections.

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The main issues in dispute are whether the Impugned Management Fees are deductible expenses under sections 16(1) and 17 of the Inland Revenue Ordinance. Alternatively, whether the entering into of the Management Agreement between the Taxpayer and Company and each payment thereunder, are transactions that have, or would have had but for section 61A, the effect of conferring a tax benefit on the Taxpayer, and having regard to the seven conditions mentioned in section 61A(a) to (g), it would be concluded that the entering into or carrying out of the transactions was for the sole or dominant purpose of enabling the Taxpayer, either alone or in conjunction with other persons, to obtain a tax benefit so that section 61A is engaged - where expenses were found not to be incurred in the production of assessable profits, there can be an apportionment of the expenditure.

Held:

1. The Board's function on hearing an appeal under section 68 of the Ordinance is to consider the matter *de novo*. (Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 followed)
2. In assessing the evidence for the determination of this appeal, representations and submissions made by the tax representative, without more, do not form part of the evidence. Assertions and submissions by tax representatives that are not supported by undisputed contemporaneous documents are not, without more, to be treated as evidence. Accordingly, we only accept those factual representations and submissions which are not disputed by the Revenue. Disputed facts must be proved by contemporaneous documents or oral evidence accepted by this Board. Mere assertions or statements of the tax representatives do not form part of the evidence. (The Commissioner of Inland Revenue v Crown Brilliance Limited, HCIA 1/2015 followed)
3. The evidence put forward by the Taxpayer which was not challenged by the Revenue could not be taken as accepted by the Revenue as the fact. The Board may consider the whole of the circumstances presented to it and find whether the oral evidence is acceptable or not. (All Best Wishes Ltd v CIR, HCIA 1/1992 and Hui Cheung Fai v Daiwa Development Ltd (HCA 1734/2009 followed)
4. The Board refused to draw adverse inference against the Taxpayer that the evidence of the Taxpayer's and/or Company A's shareholder and/or director would not assist the Taxpayer's case. The Taxpayer bears the burden of proving its case. In the absence of documentary evidence and oral evidence from reliable witness(es) on these pertinent issues, the result would be that the Taxpayer could not come to proof on the issues it contended. (Cavendish Funding Ltd v Henry Spencer & Sons Ltd [1998] PNLR 122; Mr D Sau Keung v Maxcredit Engineering Ltd [2004] 1 HKC 434; and Telings International Hong Kong Ltd v John Ho, CACV 10/2010)

considered)

5. The Board did not agree that since the Revenue had accepted certain items of expenditure as deductible expenses, it followed under section 16 of the Ordinance that all of the expenses had to be deducted. The Board also did not agree that deductions of the Impugned Management Fees must be allowed unless it is required to be disallowed by operation of other provisions of the Ordinance. The Board considered that a plain reading of section 16 of the Ordinance, especially the words ‘all outgoings and expenses to the extent to which they are incurred ... in the production of profits’ shows that the permissible deduction of ‘all outgoings and expenses’ is qualified by the condition that they are allowed to the extent they produce profits. Where expenses were found not to be incurred in the production of assessable profits, there can be an apportionment of the expenditure. We agree with the Revenue on this point. The Board also repeat rule 2A of the Inland Revenue Rules, which provides the statutory basis for apportionment. (So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416; D25/07 22 IRBRD 596; D96/89 6 IRBRD 364; and D71/97 12 IRBRD 410 followed)
6. It remains the task of this Board to examine the evidence and make a finding of fact as to whether the Impugned Management Fees were expenses incurred in the production of the assessable profits. If yes, they are deductible under section 16 of the Ordinance. If not, deduction should not be allowed. If only part of such expenses is found to be incurred in the production of the assessable profits, it may call for an apportionment. (Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296 distinguished)
7. The Commissioner accepted the principle that it is not open to the Commissioner to disallow deductions simply on the basis that the Impugned Management Fees are unreasonable or excessive, but the Commissioner contended that he had not done so. The Commissioner contended that he is entitled to consider whether the surrounding circumstances objectively, including whether the amount is arbitrary, lack of commercial reality and thus not bona fide. (D94/99 14 IRBRD 603 followed)
8. The Board found that Company A had its operation and is not a ‘sham’ or mere ‘bookkeeping entity’. Company A had performed the tasks under the Management Agreement. The Management Fees Per Written Agreement was charged at a fix agreed rate set out in the Management Agreement. Having evaluated all the evidence, we are satisfied that the Management Fees Per Written Agreement are deductible expenses under sections 16 and 17 of the Ordinance.
9. Section 61A is not a charging provision. It is an alternative provision to

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sections 16 and 17 of the Ordinance A tax benefit in the statutory sense is required before section 61A is engaged, so that section can apply only to a transaction which would otherwise avoid tax. (Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 followed)

10. The following three intersecting conditions must be satisfied before the Commissioner can exercise the power to raise an assessment under section 61A(2): (a) a transaction (broadly defined to include an operation or scheme) has been entered into; (b) such transaction has, or would have had but for this section, the effect of conferring a tax benefit on the relevant person (that is, on the taxpayer against whom the section has been invoked); and (c) viewing the transaction through the prism of the seven matters enumerated in section 61A(1)(a) to (g), 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. (Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296 followed)
11. A transaction that serves a proper commercial purpose can still be caught by section 61A as for the sole and dominant purpose of conferring a tax benefit. It is a matter of degree and facts. (FTC v Spotless Service Ltd [1996] 186 CLR 404; D25/15 (2016-17) 31 IRBRD 270; and Commissioner of Inland Revenue v Tai Hing Cotton Mill Development Ltd (2007) 10 HKCFAR 704 followed)
12. The Board found that the Taxpayer's liability to tax would be lower by interposing the Transaction which enable a deduction of the Management Fees Per Written Agreement in the Taxpayer's assessment for tax. The Transaction thus has the effect of conferring a tax benefit on the Taxpayer, but for the operation of section 61A. The next question is whether the Transaction was entered into with the sole or dominant purpose of obtaining a tax benefit. This question was not to be answered by accessing the actual or subjective purpose of the parties, but is to be viewed objectively after considering the various matters listed in paragraphs (a) to (g) of section 61A(1). (Commissioner of Inland Revenue v Tai Hing Cotton Mill Development Ltd (2007) 10 HKCFAR 704 followed)
13. Having viewed all the circumstances objectively, the Board concluded that the Transaction was entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit. In conclusion, we find that section 61A of the Ordinance is engaged. A remittance to the Commissioner for the apportionment of expenses would be an academic exercise and is not necessary.

Appeal dismissed

Cases referred to:

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Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 [30]
The Commissioner of Inland Revenue v Crown Brilliance Limited, HCIA 1/2015
All Best Wishes Ltd v Commissioner of Inland Revenue (1992) 3 HKTC 750
Hui Cheung Fai v Daiwa Development Ltd (HCA 1734/2009, 8 April 2014)
Cavendish Funding Ltd v Henry Spencer & Sons Ltd [1998] PNLR 122
Li Sau Keung v Maxcredit Engineering Ltd [2004] 1 HKC 434
Telings International Hong Kong Ltd v John Ho (unrep., CACV 10/2010)
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416
D25/07, (2007-08) IRBRD, vol 22, 596
D96/89, IRBRD, vol 6, 364
D71/97, IRBRD, vol 12, 410
Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296
D94/99, IRBRD, vol 14, 603
FTC v Spotless Service Ltd [1996] 186 CLR 404
D25/15, (2016-17) IRBRD, vol 31, 270
Commissioner of Inland Revenue v Tai Hing Cotton Mill Development Ltd (2007) 10 HKCFAR 704

Johnny Mok, Senior Counsel, instructed by Messrs J Chan & Lai, for the Appellant.
Elizabeth Cheung, Counsel, instructed by the Department of Justice, for the Commissioner of Inland Revenue.

A. Decision

1. This is an appeal against the Deputy Commissioner's Determination dated 10 July 2019 ('Determination') whereby,
 - 1.1. Additional Profits Tax assessments for year of assessment 1997/98 dated 26 March 2004, showing Additional Assessable Profits of \$37,857,690 with Additional Tax Payable thereon of \$5,621,867 was confirmed;
 - 1.2. Additional Profits Tax assessments for year of assessment 1998/99 dated 29 March 2005, showing Additional Assessable Profits of \$48,840,872 with Additional Tax Payable thereon of \$7,814,540 was confirmed;
 - 1.3. Additional Profits Tax assessments for year of assessment 1999/2000 dated 27 March 2006, showing Additional Assessable Profits of \$50,337,739 with Additional Tax Payable thereon of \$8,054,039 was confirmed;

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- 1.4. Additional Profits Tax assessments for year of assessment 2000/01 dated 27 March 2006, showing Additional Assessable Profits of \$55,403,074 with Additional Tax Payable thereon of \$8,864,491 was confirmed;
- 1.5. Additional Profits Tax assessments for year of assessment 2001/02 dated 27 March 2006, showing Additional Assessable Profits of \$82,272,150 with Additional Tax Payable thereon of \$13,163,544 was confirmed;
- 1.6. Additional Profits Tax assessments for year of assessment 2002/03 dated 27 March 2006, showing Additional Assessable Profits of \$42,565,356 with Additional Tax Payable thereon of \$6,810,457 was confirmed;
- 1.7. Profits Tax assessments for year of assessment 2003/04 dated 27 March 2006, showing Assessable Profits of \$58,399,956 with Tax Payable thereon of \$10,219,992 was increased to Assessable Profits of \$61,959,916 with Tax Payable thereon of \$10,842,985;
- 1.8. First Additional Profits Tax assessment for the year of assessment 2004/05 dated 27 March 2006, showing Additional Assessable Profits of \$22,051,090 with Additional Tax Payable thereon of \$3,858,940 was reduced to Additional Assessment Profits of \$20,840,261 with Additional Tax Payable thereon of \$3,647,045;
- 1.9. Profits Tax assessment for the year of assessment 2005/06 dated 15 March 2012, showing Assessable Profits of \$2,167,056 with Tax Payable thereon of \$379,234 was annulled.
(Collectively 'Assessments').

2. The subject matter of this appeal concerns the management fee ('Management Fees') paid by the Taxpayer to its related company, Company A during the relevant years of assessment. The Taxpayer claimed for the deduction of the Management Fees. The Commissioner allowed the deduction of the bank charges and administrative expenses incurred by Company A under sections 16 and 17 of the Inland Revenue Ordinance ('the Ordinance') but disallowed the deduction of the remaining sum ('Impugned Management Fees').

3. The Impugned Management Fees were essentially the operating profits of Company A in the relevant years, except for a minor difference of around \$3,559,960 for the year 2003/04.

4. The main issues in dispute are:

- 4.1. whether the Impugned Management Fees are deductible expenses under sections 16(1) and 17 of the Inland Revenue Ordinance ('Ordinance');
- 4.2. alternatively, whether the entering into of the Management Agreement between the Taxpayer and Company A dated 1 April 1997 ('Management Agreement') and each payment thereunder, are transactions that have, or would have had but for section 61A, the effect of conferring a tax benefit on the Taxpayer, and having regard to the seven conditions mentioned in section 61A(a) to (g), it would be concluded that the entering into or carrying out of the transactions was for the sole or dominant purpose of enabling the Taxpayer, either alone or in conjunction with other persons, to obtain a tax benefit so that section 61A is engaged.

B. Background Facts

5. The Taxpayer is a company incorporated in Hong Kong on 5 September 1991, with a business address in Hong Kong. Its shareholders are Company B, Mr C and Mr D. Company B is a subsidiary of Company E.
6. During the period between 1 April 1997 and 31 December 2005, Company B was the majority shareholder of the Taxpayer, holding 50.4% shares, the remaining shares were held by Mr C and Mr D, initially 25% and 24.6% respectively, and from 22 January 2003 to 31 December 2005, each of Mr C and Mr D held 24.8% shares of the Taxpayer.
7. The Taxpayer's principal activity was the manufacturing and trading of fabric and yarn and provision of trade related services. It became dormant in 2005.
8. Company A was incorporated in the BVI on 1 May 1996. As at 31 December 2003, the shareholders of Company A was the same as those of the Taxpayers.
9. At all material times, Company A and the Taxpayer had common directors, namely, the two shareholders, viz: Mr C and Mr D, as well as a Mr F and a Mr G.
10. The correspondence address of Company A was the same as the Taxpayer's business address.
11. The ultimate holding company of the Taxpayer and Company A was a Bermuda company named Company H, which was listed on the Stock Exchange of Hong Kong in 1996. The Company H and its subsidiaries ('H Group') were engaged in the retailing, export and production of casual wear.
12. The Taxpayer holds a majority shareholding interests (ranging from 90% to 100%) in two enterprises in the Mainland, namely Company J and Company K. They used to be the manufacturing arm of the Taxpayer. Company J and Company K are collectively referred to as 'PRC Factories'.

13. Company J was incorporated in 1993. Mr C was its legal representative. Its principal activities were knitting and dyeing of yarn into fabric. It ceased its knitting business in 2002.

14. Company K was incorporated in 1993. It became wholly owned by the Taxpayer in 2003. Mr D was its legal representative. The principal activities of Company K were the production and sale of knitted and dyed fabric as well as trading of garment accessories and related products.

15. Company A was not registered in Hong Kong and the Mainland, neither had it paid tax in these two places.

C. The Management Arrangements

16. It is the Taxpayer's case that prior to the listing of the Company H in September 1996, it was decided that the companies within the H group would be segregated into different functional units in order to enhance the transparency of returns and profitability of each functional units, and have better management and accountability to its public shareholders.

17. In addition to the Taxpayer (incorporated in 1991), the PRC Factories (incorporated in 1993), Company A was incorporated in the BVI in 1996. They formed the three functional units.

18. The Taxpayer took orders for fabrics and placed them with the PRC Factories or third party manufacturers. The PRC Factories was the manufacturing arm. Company A provided production management services.

19. By the Management Agreement dated 1 April 1997, the Taxpayer as the principal, appointed Company A as its agent for fabric production with effect from 1996. The Management Agreement was signed by Mr C and Mr D on the respective behalf of the Taxpayer and Company A.

20. The Recitals of the Management Agreement are as follows:

- '(a) The [Taxpayer], in its ordinary course of business, is required to purchase dyeing and knitted fabric to be made in the People's Republic of China ... to its order.
- (b) [Company A] has strong connections with various knitting and dyeing factories in China, and with expertise and manpower to support and supervise the proper and efficient production of knitted and dyed fabric by those factories in China.
- (c) The [Taxpayer] has agreed to appoint [Company A] to be its management agent for its China factories fabric production on the

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terms and conditions herein provided.'

21. Clause 2 of the Management Agreement sets out Company A's obligations, *inter alia*, as follows:

21.1. Clause 2.1: Company A 'will provide production sources and outlets in China factories to the [Taxpayer] which may be suitable for the production and delivery requirements of the [Taxpayer]'.

21.2. Clause 2.2: Company A 'will provide production management services, technical support and liaison services to the concerned China factories in connection with the production orders to be so placed by the [Taxpayer]'.

21.3. Clause 2.3: Company A 'will provide quality control and inspection service for the dyed and knitted fabrics in China factories on behalf of the [Taxpayer] and upon satisfactory inspection of the products, will sign the Inspection Certificates in such forms as prescribed by [the Taxpayer] on behalf of the [Taxpayer]'.

21.4. Clause 2.5: Company A 'will conduct such market research as may reasonably be required in China factories on market trends, new items, sources of supply, price and quality'.

21.5. Clause 2.9: Company A 'will inspect all commercial and customs documents on behalf of the [Taxpayer] to ensure that they accurately reflect the transaction and are drawn in the proper manner as required by the regulations of both the exporting and importing countries'.

22. Clause 3 of the Management Agreement provides that:

'In consideration of [Company A]'s performance of the services herein stated, the [Taxpayer] shall pay to [Company A] a service fee of HKD1.40 per lb for dyed fabrics and HKD0.30 or any other rate as may be mutually agreed upon by the parties hereto, so ordered by the [Taxpayer] and manufactured and shipped in China under the supervision of [Company A].

As a separate and additional covenant [Company A] shall ensure that all the goods produced under the supervision of [Company A] or the production of which is contemplated by the terms of this agreement to be under the supervision of [Company A] be of top and acceptable quality as to fabrics, workmanship, packing and delivery and that [Company A] shall be responsible for all claims, demands, compensation price discount and legal costs and other incidental expenses incurred or arising out of or in connection with any claim of the [Taxpayer]'s purchasers in respect of the said

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goods’.

23. Clause 4 of the Management Agreement provides that the Taxpayer ‘shall pay and settle the service fee of [Company A] within one month after presentation of [Company A]’s monthly statement’.

24. Clause 5 of the Management Agreement provides that the agreement ‘shall remain in full force until determined by either party by giving not less than THREE (3) calendar months’ notice in writing to the other party’.

25. Initially, employees of the Taxpayer and other companies in the Group were transferred to Company A. At a later stage, Company A also employed its own staff. They stationed in the PRC Factories.

26. The Taxpayer has provided the Revenue documents setting out the management fee charged for the years of assessment 1997/98 to 2004/05, on which the following information was shown (‘Table 1’):

Year/ period ended	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.XX.XX XX *	XX.XX.XX XX	XX.XX.XX XX
	\$	\$	\$	\$	\$	\$	\$	\$
(i) dyed fabric	38,679,223	43,968,513	45,576,241	50,182,602	75,602,959	37,481,194	49,968,120	17,069,756
Rate per pound	1.63	2.00	2.00	2.00	2.80	1.75	1.84	1.50
(ii) dyed thread	--	195,058	708,925	635,952	763,092	467,846	612,061	257,556
Rate per piece	--	0.40	0.40	0.40	0.50	0.40	0.40	0.40
(iii) knitted fabric	6,208,771	10,053,747	11,390,992	12,561,423	16,366,330	9,361,571	12,764,606	4,723,778
Rate per pound	0.30	0.50	0.50	0.50	0.70	0.45	0.50	0.50
Total management fee	44,887,994	54,217,318	57,676,158	63,379,977	92,732,381	47,310,611	63,344,787	22,051,090

* covered the period from X.X.XXXX to XX.XX.XXXX

27. The following analysis shows the profit margins of the Taxpayer and Company A with respect to the sales of the Taxpayer for the relevant years/period (‘Table 2’):

Year of assessment	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	1997/98 to 2004/05
Year/period ended	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.X.XX XX	XX.XX.X XXX *	XX.XX.X XXX *	XX.XX.X XXX *	
	\$	\$	\$	\$	\$	\$	\$	\$	\$
<u>Taxpayer</u>									
<u>Sales</u>	317,482,588	458,605,983	500,634,614	571,395,642	562,576,898	449,940,507	531,454,328	202,355,853	3,794,446,413

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<u>Management fee to Company A</u>	<u>44,887,994</u>	<u>54,217,318</u>	<u>57,676,158</u>	<u>63,379,977</u>	<u>92,732,381</u>	<u>47,310,611</u>	<u>63,344,787</u>	<u>22,051,090</u>	<u>445,600,316</u>
<u>% of management fee to sales</u>	<u>8.67%</u>	<u>11.82%</u>	<u>11.52%</u>	<u>11.09%</u>	<u>16.4%</u>	<u>10.51%</u>	<u>11.92%</u>	<u>10.90%</u>	<u>11.74%</u>
<u>Assessable Profits</u>	<u>4,366,969</u>	<u>13,845,135</u>	<u>9,804,286</u>	<u>10,222,900</u>	<u>10,176,061</u>	<u>9,460,802</u>	<u>2,093,549</u>	<u>990,018</u>	<u>60,959,720</u>
<u>% of Assessable Profits to sales</u>	<u>0.84%</u>	<u>3.02%</u>	<u>1.96%</u>	<u>1.79%</u>	<u>1.81%</u>	<u>2.10%</u>	<u>0.39%</u>	<u>0.49%</u>	<u>1.61%</u>
<u>Company A</u>									
<u>Operating profits</u>	<u>37,857,690</u>	<u>48,840,872</u>	<u>50,337,739</u>	<u>55,403,074</u>	<u>82,272,150</u>	<u>42,565,356</u>	<u>59,866,367#</u>	<u>20,840,261</u>	<u>397,983,509</u>
<u>% of profit to sales of Taxpayer</u>	<u>7.32%</u>	<u>10.65%</u>	<u>10.05%</u>	<u>9.70%</u>	<u>14.62%</u>	<u>9.46%</u>	<u>11.26%</u>	<u>10.30%</u>	<u>10.49%</u>

* covered the period from X.X.XXXX to XX.XX.XXXX
 # \$56,306,407 + \$3,559,960 = \$59,866,367

D. The Tax Assessments

28. The Assessor raised profits tax assessments for the years of assessment 1997/98 to 2002/03 and 2004/05 in accordance with the declared profits of the Taxpayer, against which the Taxpayer raised no objection.

29. In February 2004, the Assessor commenced a tax audit on the Taxpayer's tax affairs. After the tax audit, the Assistant Commissioner considered that the Impugned Management Fees paid by the Taxpayer were not deductible under sections 16 and 17 of the Ordinance. The Assistant Commissioner was also of the view that the appointment of Company A as management agent of the Taxpayer was a transaction carried out for the sole and dominant purpose of enabling the Taxpayer to obtain a tax benefit, and section 61A of the Ordinance shall apply. The Impugned Management Fees made to Company A should be regarded as the profits of the Taxpayer and be assessed on the Taxpayer under section 61A(2)(b) of the Ordinance to counteract the tax benefit which would otherwise be obtained. The assessments for the years of assessment of 2003/04 and 2005/06 as well as the first additional Profits Tax assessment for the year of assessment of 2004/05 were recomputed accordingly.

30. The Taxpayer raised objections.

E. The Determination

31. By the Determination, the Deputy Commissioner confirmed the Assessments. In gist, the Deputy Commissioner took the view that:

31.1. The Management Fees made to Company A were disproportionate and grossly excessive in relation to the services that the Taxpayer contended Company A had provided. The Taxpayer failed to prove that the benefits conferred by the Management Agreement had

provided an objective commercial justification for deduction of the whole of the Management Fee claimed. The Deputy Commissioner therefore could not accept that the whole amount of management fee claimed was allowable expenses under sections 16(1) and 17(1)(b).

- 31.2. Alternatively, on an objective assessment of the facts stated in the Determination, in particular, the manner in which the two related companies dealt with each other, the excessive profit margins, the divergence between form and substance with Company A actually undertaking minimal contractual services and the on-going nature of the service arrangement, notwithstanding the adverse impact on the Taxpayer's profitability. The Deputy Commissioner considered that there was no commercial justifications in interposing Company A into the Taxpayer's group. The enlarged group structure did not create any economic synergies which would result in an increase in the overall profits of both the Taxpayer and Company A as a whole. The arrangement merely brought into existence new source of non-taxable income for Company A as well as great amount of deductions by the Taxpayer. It bore no characteristics of a rational commercial reality and it was a convoluted plot to avoid tax. The Deputy Commissioner took the view that section 61A(1) of the Ordinance is applicable as the sole and dominant purpose of the Taxpayer's entering into the Management Agreement was to enable the Taxpayer to obtain a tax benefit in the form of reduction of its profits tax liability.

F. The Grounds of Appeal

32. The Taxpayer appealed to this Board on the grounds summarised below.

33. The Taxpayer contended that each of the Taxpayer, Company A and the PRC Factories are different functional units of a group companies engaged in garment and fabric manufacturing business ('Group').

34. The Taxpayer's function was to take orders for fabrics and place orders with either of the PRC Factories which were acquired by the Group or with independent third party manufacturers, and to solicit orders from outside garment manufacturers (amounting to 15% of its total sale volume). A majority of its business (85%) was from a related company named Company L. For such function, it kept a small team of staff. The Taxpayer's profits are derived from the sale of the fabrics.

35. The PRC Factories' function was to manufacture and process the fabrics for the orders placed by the Taxpayer. The Taxpayer paid manufacturing and processing fees to the PRC Factories.

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36. Company A's function was to, provide professional services of *inter alia* managing, supervising and providing technical support to the manufacturing processes at the PRC Factories, and ensuring the quality control and providing inspection services for the fabric produced at the PRC Factories. As such, Company A employed a larger staff team than the Taxpayer, and the staff were more senior, professionally skilled and high-value, compared with the workers of the Taxpayer and the PRC Factories. It undertook significant tasks to ensure the top and acceptable quality of the fabrics, workmanship, packing and delivery as well as assume the risk of claims of the Taxpayer's purchasers in respect of the goods.

37. The Management Fees charged were not arbitrary.

38. Clause 3 of the Management Agreement provided that the rate of the service fee 'may be mutually agreed upon by the parties'. The Management Fees charged by Company A were calculated by multiplying the weight of manufactured goods by a pre-determined rate negotiated and fixed every year by the management of the Taxpayer and Company A to reflect the contribution by Company A. The sums charged were commensurate with the professional management and supervisory services provided by and the significant tasks undertaken by Company A.

39. The tripartite mode of production of manufacturing the goods at the PRC Factories under the professional management and supervision of Company A would save HK\$2.89 per lb when compared to the manufacturing costs if the Taxpayer were to place orders with independent third party manufacturers.

40. The Management Fees paid by the Taxpayer were not economically unreasonable with respect to the sales and profit margins of the Taxpayer. It is contended that Company A's relatively higher profit margin was commensurate with the professional management and quality control services performed by its more senior and skilled management staff, and the significant risks undertaken by Company A under Clause 3 of the Management Agreement. The Taxpayer's relatively lower profit margin was commensurate with its limited role of soliciting and placing orders, which required only a small team of staff.

41. The reasonableness of the Management Fees paid to Company A is also evident from the fact that the tripartite mode of production of manufacturing the goods at the PRC Factories under the management of Company A would save HK\$2.89 per lb when compared to the manufacturing costs if the Taxpayer were to place orders with independent third party manufacturers.

42. In regard to the Revenue's contention that section 61A of the Ordinance is applicable, the Taxpayer contended that:

42.1. the mode of production engaging the services of Company A and PRC Factories is more cost-saving and would in turn produce more profits for the Taxpayer when compared to the alternative mode of production by engaging independent third party manufacturers only.

- 42.2. As to the manner in which the transaction was entered into or carried out: the transaction involved the setting up of manufacturing businesses by three different arms (the Taxpayer, the PRC Factories and Company A) for the commercial purpose of reducing manufacturing costs and increasing the profits of the Taxpayer. The Management Fees were not arbitrary, disproportionate or grossly excessive taking into account the role and functions of and significant risks undertaken to Company A.
- 42.3. As to the form and substance of the transaction: Company A performed real and substantive functions, and undertook significant risks in respect of the manufactured goods. In particular, the Commissioner erred in concluding that Company A bore minimal or no business risk because there was no compensation expenses charged in the accounts of Company A for the relevant periods. In fact, no compensation claims had been made by the customers at all, which was due to the excellent performance of Company A and timely replacement of inferior quality products.
- 42.4. As to the result in relation to the operation of the Ordinance that, but for section 61A, would have been achieved by the transaction: The result was that the Taxpayer's profits were increased (and more profits tax become payable) when compared to the alternative mode of production where only independent third party manufacturers were engaged.
- 42.5. Company A would profit from the Management Fees, which was commensurate with the services it rendered to the Taxpayer and the significant risks it undertook pursuant to the Management Agreement. The profits were not taxable in Hong Kong only because the functions of Company A were carried out outside Hong Kong. However, Company A made provisions for contingency in accordance with the recommendation of auditors which considered that Company A might have corporate tax implications in the PRC, such provisions being based roughly on a percentage of the profit of Company A for the relevant years.
- 42.6. The tripartite arrangement amongst the Taxpayer, the PRC Factories and Company A is a comparable, alternative mode of production to the two-party arrangement between the Taxpayer and independent third party manufacturers. However, the former mode of production was more cost-saving.
- 42.7. Both Company A and the PRC Factories were incorporated outside Hong Kong.

G. The Board's Approaches

43. The Taxpayer's appeal is against the Assessments. The Board's function on hearing an appeal under section 68 of the Ordinance is to consider the matter *de novo*. (Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 [30])

44. Under section 68(8)(a) of the Ordinance, the Board, after hearing the appeal, shall confirm, reduce, increase or annul the assessment appealed against or may remit the case to the Commissioner with the opinion of the Board thereon.

45. Section 68(4) of the Ordinance provides that the Taxpayer bears the onus of proving the Assessments are excessive or incorrect.

46. The Taxpayer adduced two witness statements:

46.1. The witness statements of Mr M, Position N within the corporate group comprising Company E and its operating subsidiaries ('E Group') from around 1995 to 2014. Since 2008, Mr M has been a Position P within the E Group.

46.2. The witness statement of Mr Q, the Position R of the corporate group comprising the Company H and its subsidiaries ('H Group') from 1991 to 2019. Since 1 January 2020, Mr Q has been working for the H Group as a part time consultant.

47. Mr M testified at the hearing of the appeal.

48. After the oral evidence of Mr M, counsel for the Taxpayer informed the Board that the Taxpayer did not call Mr Q to give evidence because it was considered that Mr Q would not add anything to the evidence given by Mr M.

49. Mr Q did not testify at the hearing. His witness statement does not form part of the evidence of this appeal.

50. In this appeal, the Taxpayer placed significant reliance in many areas on the representations and submissions made by its tax representative to the Revenue during the period of investigation.

51. It is trite that in assessing the evidence for the determination of this appeal, representations and submissions made by the tax representative, without more, do not form part of the evidence. Assertions and submissions by tax representatives that are not supported by undisputed contemporaneous documents are not, without more, to be treated as evidence. This principle and practice of the Board were confirmed by Hon. G Lam J in The Commissioner of Inland Revenue v Crown Brilliance Limited, HCIA 1/2015 at [17] to [19]:

'17. As to the power of the Board to admit evidence, s. 68(7) provides:

“At the hearing of the appeal the Board may, subject to the provisions of section 66(3), admit or reject any evidence adduced, whether oral or documentary, and the provisions of the Evidence Ordinance (Cap 8), relating to the admissibility of evidence shall not apply.”

18. *The above features of the procedure of an appeal before the Board were, I believe, understood by the Board. Where it went wrong, with respect, was in treating the representations that had been made by the tax representative in letters to the Revenue as agreed facts or effectively unchallenged evidence, when those matters were in fact contentious.*
19. *In the present context, I accept the submission of Mr Leung, who appeared for the Commissioner on this appeal, that a fact is not proved by its assertion in argument. It is proved by evidence, oral or documentary. The representations and oral submissions made by the tax representative, without more, do not amount to evidence. This has been the practice of the Board itself: see Board of Review Decisions Nos. D7/08 at §64, D35/10 at §§12-13, D18/13 at §50 and D28/12 at §§16-17. Mr Leung accepted that the contemporaneous documents submitted by the tax representative, at any rate those documents whose authenticity is not in dispute, may be considered by the Board as admissible documentary evidence. But the assertions and submissions that are not supported by the undisputed contemporaneous documents stand on a different footing and ought not, without more, to be treated as evidence.’*

(emphasis added)

52. Accordingly, we only accept those factual representations and submissions which are not disputed by the Revenue. Disputed facts must be proved by contemporaneous documents or oral evidence accepted by this Board. Mere assertions or statements of the tax representatives do not form part of the evidence.

53. Further, the evidence put forward by the Taxpayer which was not challenged by the Revenue could not be taken as accepted by the Revenue as the fact. The Board may consider the whole of the circumstances presented to it and find whether the oral evidence is acceptable or not. In this connection, we repeat the following decision of Mortimer J in All Best Wishes Ltd v CIR, HCIA 1/1992

- ‘44. *A tribunal, which hears oral evidence and considers documents, is not in the position (as is submitted) that it has to find what the witness says is the fact, even if he is not cross-examined, and even if he is not contradicted by other evidence. A tribunal, in those circumstances, may look at the whole of the circumstances presented to it and may find that the oral evidence is not acceptable on particular matters. Or, may find certain facts contrary to the evidence that has been given*

and, indeed, contrary to what appears in the documents and other material before it.'

54. In our fact finding exercise, we are guided by the general principles helpfully summarised in Hui Cheung Fai v Daiwa Development Ltd (HCA 1734/2009, 8 April 2014 at [76] to [83]), in particular:

- 54.1. generally speaking, contemporaneous written documents and documents which came into existence before the problems in question emerged are of the greatest importance in assessing credibility;
- 54.2. in deciding whether to accept a witness' account, importance should also be attached to the inherent likelihood or unlikelihood of an event having happened, or the apparent logic of events; consistency of the witness' evidence with undisputed or indisputable evidence, and the internal consistency of the witness' evidence, such internal consistency is often tested by a comparison between the witness' oral testimony and his witness statement;
- 54.3. we cautioned ourselves against the dangers of too readily drawing conclusions about truthfulness and reliability solely or mainly from the appearance of witnesses or from the assessment of the witnesses' character;
- 54.4. the more serious the allegation sought to be proved is, the more cogent the evidence relied upon to support it must be.

55. We adopt the above principles in the approaches and consideration of the evidence before us.

H. Evidence of Mr M

56. Mr M is the only witness for the Taxpayer. He did not have any position within the Taxpayer at the material times. He admitted that he did not have direct personal knowledge on most, if not all, of the matters in connection with the Management Agreement and how it was implemented. His knowledge of the management and operation of the Taxpayer and Company A was obtained through regular meetings of the Executive Committee of E Group held on monthly basis.

57. Mr M stated, *inter alia*, the following in his witness statement:

- 57.1. Prior to the listing of the Company H in September 1996, the management of Company H decided that as a matter of overall management philosophy, the companies within the Company H corporate group should be segregated into different functional units in order to enhance the transparency of returns and profitability of

each function for better management and accountability to its public shareholders.

57.2. This management philosophy applied to the E Group, which was the 'Knitwear Division' under Company H, which includes the Taxpayer, Company A and the PRC Factories.

57.3. Company A was established in 1996 as a separate functional unit to provide production management and technical services to the dyeing and knitting processes carried out by the PRC Factories and the dyeing factories to be established in Country S, the latter of which did not materialise. Mr M specifically mentioned that he was the person in charge of the establishment in Country S.

57.4. The division of functions between the PRC Factories and Company A was reflected in the Management Agreement.

57.5. During the Executive Committee meetings of the E Group (which Mr M attended personally), the fixing of the service fee stated in the Management Agreement was discussed. He stated in [10] of his witness statement the gist of the discussion as follows:

'(1) The Taxpayer recognised that the position of Company A in production management was analogous to sourcing agents for garments, where sourcing agents would be responsible for the quality control of garment products and would themselves assume risks of product defect.

(2) In the garments sourcing industry, it was common to pay commission at around 6% of the sale price to such sourcing agents.

(3) Since the average sale price for mid-price ranged dyed fabrics at the time was around HK\$23/lb, applying the 6% margin, the management fees under Management Agreement was initially fixed at HK\$1.4/lb, to be reviewed on a yearly basis thereafter.'

57.6. Company A had around 8 to 10 staff at the material times, all of them stationed at the PRC Factories to provide direct production management services. Mr M gave description on the position and job nature of some of the staff.

57.7. He also stated in [12] of his witness statement about the PRC Factories' performance as follows:

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‘As a result of the technical know-how and other production management services provided by Company A to the PRC Factories, as well as upgrade in the machines and other facilities of the same:-

- (1) There was a significant increase in the production capacity of the PRC Factories, as well as a decrease in production costs of the same.
- (2) The PRC Factories became known in the Pearl-Delta region to offer top-quality knitting and dyeing work, and to have one of the best (if not the best) technical skills in the region.’

58. The Taxpayer had not produced any minutes of the Executive Committee meeting recording the resolution or discussion on the fixing of the management fee, or other disputed issues concerning the parties’ arrangements in connection with the Management Agreement.

59. As it transpired at the oral testimony of Mr M, he did not have direct knowledge of most of these matters. In connection with most of the areas of evidence offered by him, he admitted that he did not have the full picture. On matters that he knew from the discussion at the Executive Committees’ meeting, he could not specify a clear source of the information with reference to, for example, the person from whom he knew about the evidence and the circumstances under which it was said.

60. Take for example, he offered to give evidence on the corporate chart following the restructuring of the E Group and attached the chart to his witness statement. When he was cross-examined on the corporate chart, he said that he gained access of the chart at the Executive Committee meeting but the chart was prepared by someone else. When he was asked further, he said *‘I knew some, but don’t know some. I did not have full direct knowledge of the whole process.’* and *‘I have some knowledge, but I don’t have full knowledge of the restructuring.’*

61. More importantly, in connection with various key areas concerning the Management Agreement, Mr M admitted that he did not have direct knowledge but only learnt them in the Executive Committee meetings; or from ‘middle level management’ who learnt from the ‘upper management’. He has not given particulars about the discussion at the Executive Committee meetings. He has not specified with precision the identity of these ‘upper management’ or the ‘middle level management’ who told him the information about matters concerning the Management Agreement. We will elaborate below some of the evidence given by Mr M on these key areas. On the whole, we are of the view that the evidence of Mr M on matters relating to the Management Agreement are not reliable.

I. Adverse Inference

62. The Revenue invited the Board to draw adverse inference against the Taxpayer that the evidence of Mr Q and the evidence of the Taxpayer's and/or Company A's shareholder and/or director would not assist the Taxpayer's case.

63. The Revenue pointed out that the Taxpayer chose not to call any shareholder or director or someone from the management who were in charge of matters concerning the Management Agreement to explain the management philosophy, to give evidence on the operation of the relevant companies and how the Management Agreement was implemented. These are pertinent issues of the appeal.

64. Further, the Revenue highlighted that Mr Q was the Position R of the corporate group and one of the joint signatories of Company A's only bank account. He has given a witness statement in this appeal. His evidence would be relevant. Bearing in mind Mr M's admission that he did not have the full picture on a number of areas, Mr Q's evidence is relevant to the issues in dispute. The Revenue submitted that there is no credible reason to explain the last minute decision not to call Mr Q to give evidence and invited the Board to draw adverse inference. (Cavendish Funding Ltd v Henry Spencer & Sons Ltd [1998] PNLR 122, 128B-E, cited in Mr D Sau Keung v Maxcredit Engineering Ltd [2004] 1 HKC 434 at 443H-444B0; Telings International Hong Kong Ltd v John Ho, CACV 10/2010, 22.10.2010)

65. We declined to draw adverse inference against the Taxpayer as invited by the Revenue. The Taxpayer bears the burden of proving its case. In the absence of documentary evidence and oral evidence from reliable witness(es) on these pertinent issues, the result would be that the Taxpayer could not come to proof on the issues it contended.

J. Whether the Impugned Management Fees are expenses deductible under sections 16 and 17 of the Ordinance

The statutory provisions on deduction of expenses

66. Section 16(1) of the Ordinance provides that:
'(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period

67. Section 17(1)(b) provides that:
'(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of—

.....

(b)..... any disbursements or expenses not being money expended for the purpose of producing such profits;

Whether the Commissioner is entitled to make apportionment of the expenses

68. The Taxpayer submitted that since the Revenue had accepted certain items of expenditure as deductible expenses, it followed under section 16 of the Ordinance that all of the expenses had to be deducted.

69. It is also contended by the Taxpayer that deductions of the Impugned Management Fees must be allowed unless it is required to be disallowed by operation of other provisions of the Ordinance. There was no such provision. In support, the Taxpayer highlighted the words ‘*all outgoings and expenses*’ in section 16 of the Ordinance.

70. We do not agree with the above submission. A plain reading of section 16 of the Ordinance, especially the words ‘*all outgoings and expenses to the extent to which they are incurred in the production of profits*’ (emphasis added) shows that the permissible deduction of ‘all outgoings and expenses’ is qualified by the condition that they are allowed to the extent they produce profits. Where expenses were found not to be incurred in the production of assessable profits, there can be an apportionment of the expenditure. We agree with the Revenue on this point.

71. The Revenue also cited the following decisions in support, to which we agree:

71.1. So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 at [27] – [28] where Chu J (as the learned JA then was) held that: ‘27 *The appellant argues that there is under the IRO no concept of a computation of expenses. He says that s.16(1) is a ‘qualifying section’ that sets out the allowable tax deductions. Section 17(1), on the other hand, is a ‘disallowing section’ that sets out the expenses that cannot be allowed, even though they are qualified under s.16. The appellant contends that where an expense is qualified as a deduction under s.16(1), so long as it is not disallowed by s.17(1), then it should be allowed in whole, and there is no room for apportionment. In other words, the appellant suggests that s.16(1) has to be read subject to s.17(1).*

28. *I am unable to accept this submission. Firstly, there is nothing in the two sections to suggest, let alone permit, such a construction. It is unsupported by any authority. Secondly, the appellant is effectively saying that once an expense of the kind recognised under s.16(1), but not disallowed under s.17(1), has been effected, then irrespective of the amount involved or the reason for it, the Revenue cannot question its genuineness or the amount of the expense. This plainly defies logic and defeats the role*

of the Revenue in determining the amount of chargeable profits.’

71.2. In D25/07 22 IRBRD 596 (Chairman Benjamin Yu SC), the board stated in [12] that in cases where expenses were only partly incurred in the production of assessable profits, apportionment of such expenditure may be called for, such that only that portion of the expenditure which was incurred for the production of assessable profits should be deductible (See [14]). The board also referred to section 2A of the Inland Revenue Rules which provides for apportionment of outgoings and expenses. The board found that the expenditure under one of the subject items was only made partially in the production of the assessable profits and an apportionment was ordered. The board dismissed the appeal against the other two items of expenditure as the taxpayer failed to adduce any evidence that these payments were incurred for the production of assessable profits.

71.3. In D96/89 6 IRBRD 364 (Chairman Anthony Neoh SC), on the basis of well established provisions under the Ordinance that *‘it is for the [t]axpayer wishing to claim a deduction from profits tax to bring himself within the provisions of section 16 of the Inland Revenue Ordinance’* (see [12]), the Board upheld the assessor’s apportionment of the huge amount of management fee paid to the taxpayer’s holding company so as to disallow the proportion attributable to expenses that were not incurred in the production of profits.

71.4. In D71/97 12 IRBRD 410 (Chairman Audrey Eu SC), the board allowed partial deductions under section 16 of interest payments as being the actual cost incurred in the production of taxable profit (see [50]).

72. For completeness, we repeat rule 2A of the Inland Revenue Rules, which provides the statutory basis for apportionment:

‘2A. General apportionment of outgoings and expenses

- (1) *No deduction shall be allowed for any outgoing or expense incurred in the production of profits not arising in or derived from Hong Kong, but where any outgoing or expense was incurred partly in the production of profits arising in or derived from within Hong Kong and partly in the production of profits arising or derived from outside Hong Kong, then, for the purpose of ascertaining the extent to which such outgoing or expense is deductible under section 16 of the Ordinance, an apportionment thereof shall be made on such basis as is most appropriate to the activities of the trade, profession or business concerned.*
- (2) *Where, apart from or in addition to the circumstances referred to in paragraph (1) as giving rise to an apportionment, it is necessary to make an*

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apportionment of any outgoing or expense by reason of it having been incurred not wholly and exclusively in the production of profits in respect of which a person is chargeable to tax under Part IV of the Ordinance, such apportionment or further apportionment, as the case may be, shall, subject to the provisions of rules 2B and 2C, be made on such basis as is most reasonable and appropriate in the circumstances of the case.'

73. The Taxpayer also relied on the following passages in Court of Final Appeal's decision in Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296 in support of its argument that the entire payment of the Management Fee ought to be deducted:

'88. *What the Board found objectionable was the fact that the purchase prices were not fixed at arm's length. That is a matter highly relevant in the section 61A context, but it does not follow that the fact that excessive prices were paid meant that section 17 should be triggered and deduction disallowed.'*

'90. *Plainly, the taxpayer had to incur the payments to DWE if it was to have goods to on-sell to its customers. The payments were therefore incurred for the purpose of producing its profits. It was therefore entitled under section 16 to deduct 'all outgoing and expenses' to the extent incurred during the relevant basis period. And the sums paid could not be said to be 'expenses not being money expended for the purpose of producing profits' so as to be excluded by section 17(1)(b).*

91 *When asked in the course of argument whether it was open to the Commissioner to disallow a deduction on the basis that a price paid was not reasonable, Mr Barlow answered, in my view correctly, that it was not. Sections 16(1) and 17(1)(b) do not require the Commissioner to compare the purchase prices deducted against market prices and to disallow deductions considered excessive. If incurred in the production of the taxpayer's profits, all outgoing and expenses are deductible according to section 16(1). Unless it can be said of a specific amount that it is not money expended for the purpose of producing the taxpayer's profits, section 17(1)(b) does not bite.'*

74. It is important to bear in mind that [87] to [92] of Ngai Lik Electronics were premised on the specific finding of the Board that the payments were made in return for the goods ordered and delivered:

'[87] *As the Board found, and indeed, as appears from its formulation of the Scheme, the payments were made in return for the goods ordered and delivered.*

.....

[92] Accordingly, on the Board's findings, the taxpayer's payments made pursuant to the Narrower Scheme were in my view deductible outgoings.'

75. It was on the basis of this finding of the Board that Ribeiro PJ held in [90] of Ngai Lik Electronics that the entire payments were incurred for the purpose of producing its profits and thus were deductible expenses even though the taxpayer's purchases were not made in accordance with the master supply agreement in that case, and rejected the taxpayer's description that the payment was 'gratuitous' and the deductions are 'impermissible', which were not the findings of the Board in that case.

76. It remains the task of this Board to examine the evidence and make a finding of fact as to whether the Impugned Management Fees were expenses incurred in the production of the assessable profits. If yes, they are deductible under section 16 of the Ordinance. If not, deduction should not be allowed. If only part of such expenses is found to be incurred in the production of the assessable profits, it may call for an apportionment.

77. The Taxpayer relied on [91] of Ngai Lik Electronics, and submitted that it is not open to the Commissioner to disallow deductions simply on the basis that the Impugned Management Fees are unreasonable or excessive.

78. The above principle is accepted by the Commissioner, but the Commissioner contended that he had not done so. The Commissioner contended that he is entitled to consider whether the surrounding circumstances objectively, including whether the amount is arbitrary, lack of commercial reality and thus not bona fide. The following decision in D94/99 14 IRBRD 603 (Chairman Audrey Eu SC) was cited in support:

'24. Mr B said that it was solely a matter for the Taxpayer and Company D as to what the fair and reasonable service would be. We accept the Revenue's submission that the matter had to be assessed objectively. That is not to say that we are lifting the corporate veil. Nor are we saying that the Taxpayer is not free to decide its own affairs. The Taxpayer is free to give away part of its income as it so wishes to a related company or to a relative or indeed to any third party. The question here is whether that payment is a deductible expense in law when computing the chargeable profits. This question must be viewed objectively. The agreement between the Taxpayer and Company D does not preclude us from examining whether the payment is or is not a deductible expense incurred in the production of profits.

*25. **Such expense must have been bona fide incurred in the production of profits. We must look at all surrounding circumstances. For example, the relation between the payer and the payee is a relevant circumstance. So is the purpose or the reason of the payment. The basis and the breakdown of the amount are also important. The lack of a rational basis may lead to the conclusion that the amount is wholly arbitrary, lacking in commercial reality, and thus not bona***

fide incurred.
(emphasis added)

Company A

79. One of the Revenue's criticisms was that Company A was not a genuine commercial reality but a 'sham' put in place to receive profits siphoned away from the Taxpayer who was its only 'client'. The Revenue highlighted, *inter alia*, the following features:

- 79.1. It was set up specifically for the purpose of acting as the 'management agent' for the Taxpayer only. It had no other customers or principals.
- 79.2. Despite it was incorporated in 1996 and charged over \$40 million management fee during its first year of incorporation, it did not open a bank account until 20 October 1997.
- 79.3. It was not registered in Hong Kong or the PRC and paid no tax in either place. It did not file any individual income tax for the staff in the PRC.
- 79.4. It has no office in Hong Kong or the PRC.
- 79.5. Its employees were stationed in the PRC Factories. Company A did not issue name cards for these staff. They used the name cards issued in the name of the PRC Factories.
- 79.6. In respect of the reports said to be produced by Company A's staff, it is not shown, on the face of these documents, that they were attributable to Company A.
- 79.7. Other entities arranged for the payment of the employees' salary and it did not have its own provident fund scheme until 2001.
- 79.8. In the notes to the financial statements published in the annual report of the Company H for the year 2001 to 2005, the Company H disclosed the Taxpayer, but not Company A, as one of its principal subsidiaries.

80. On the other hand, the Taxpayer referred to the following to support that Company A had its existence and operation:

- 80.1. Company A did have its own employees (either employed by it or transferred from other companies), who carried out actual operations in the PRC, conducting tasks undertaken in the Management

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Agreement. The Commissioner had accepted, as shown in the Determination, that Company A had its own staff.

- 80.2. The Commissioner accepted that Company A had salary expenses and allowed the deduction of these expenses.
- 80.3. Mr M's witness statement stated that Company A had around 8 to 10 staff at the material times. Although there are some discrepancies in the names of staff testified by Mr M, this does not negate the evidence that Company A did have its own employees, and had paid or reimbursed the salaries of its employees.
- 80.4. Company A had opened its own bank account. On 20 October 1997, the board of Company A resolved to open a bank account with Standard Chartered Bank. The minutes of Company A dated 20 October 1997 was produced and was not disputed.
- 80.5. Before Company A had its own bank accounts, the salaries of Company A's staff were made by E Group companies on behalf of Company A. These sums had been recorded in the ledger of Company A under the item of administrative expenses. According to the ledger of Company A, Company A had reimbursed to those who paid these salaries on its behalf.
- 80.6. The documents show that Company A had paid salaries to its staff since November 1997 after its own bank account was set up. There was one exception as showed in the entry on 31 March 1998 in Company A's ledger described as 'salary by paid Chapman' in the sum of HK\$28,000.
- 80.7. The staff of Company A carried out its works in the PRC Factories.
- 80.8. It is accepted that Company A was not registered in Hong Kong or the PRC. There was no evidence before the Board on the PRC laws and regulations in this respect. Even if it is correct that the carrying out of commercial activities in the PRC without registration was in contravention of the PRC laws, it is a matter for the PRC authorities.
- 80.9. The list of the subsidiaries in the financial statement of Company H was not meant to be an exhaustive list.

81. We have carefully considered all the evidence as a whole. Company A might have relied on its related companies in some aspects of its operation and had not carried out its own business in a way wholly distinct from its related companies. However, on balance, we do not find that Company A is a mere 'sham'. Company A had its own staff, either employed by it or transferred to it from other companies. There were records of salary payments. Insofar as the salaries were paid by related companies, Company A had

made reimbursements accordingly. Company A had its own bank account. There is evidence that they had operations carried out in the Mainland. We do not find that Company A is an ‘invisible entity’ or ‘bookkeeping entity’ as the Revenue described.

The Management Agreement

82. It is the Taxpayer’s case that the Management Fees were paid to Company A for its services performed pursuant to the Management Agreement and therefore are expenses in the production of the Taxpayer’s assessable profits. Hence, it is crucial to review the Management Agreement and how it was carried out.

83. The Management Agreement was signed by the parties. It is odd that the Management Agreement was stated to take effect even prior to the incorporation of Company A. Nevertheless, there is no suggestion that the Management Agreement would be rendered unenforceable entirely.

84. There is no real dispute that the Management Agreement was not entered into on an arm’s length basis. This does not follow as a matter of course that the fees paid pursuant to the Management Agreement were not deductible expenses. ([88] of Ngai Lik Electronics) This is a matter relevant to the consideration in the context of section 61A which we will deal with below. In considering whether the Impugned Management Fees are deductible expenses or not, the test under sections 16 and 17 is whether they were incurred in the production of the assessable profits.

85. One important feature in the present case is that the sums claimed by the Taxpayer was not all calculated according to the written provisions of the Management Agreement.

86. The following are some of the examples:

86.1. There were management fees charged for 1998/99 to 2004/05 in connection with fees for dyed thread which were not provided for in the Management Agreement or any other agreement proved by the Taxpayer.

86.2. For the 12 months from April 1997 to March 1998, the Taxpayer provided a set of 12 debit notes issued by Company A for each of the months described to be management fees with breakdown for charges of ‘knitting’ at HK\$0.30 per lb, and ‘dyeing’ at HK\$1.40 per lb. One of them was dated 31 March 1998 at a total amount of HK\$4,392,985.24. There was an additional debit note dated the same date described to be Management Fee for the month of March 1998 at a lump sum of HK\$5.4 million (‘5.4 Million Debit Note’). There was no breakdown in this 5.4 Million Debit Note.

86.3. In the Taxpayer’s financial statement for the year ended 31 March 1998, the total amount of management fee paid to related companies

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was stated to be \$39,487,994. Although the \$5.4 million was stated to be the fees for the period within the financial year of 1997/98, it was not included in the financial statements.

86.4. Another example is a debit note issued by Company A dated 31 March 2002 for a total sum of HK\$33,815,233.91 described as ‘ADJUST: Management Fee For the Month of 04/01-03/02’.

86.5. According to a table provided by the Taxpayer, the rate of management fee said to be charged by Company A in different years varied. For example, the rate charged for dyeing fabrics for the year of 1997/1998 was charged at HK\$1.63 per lb, and it changed to HK\$2.0 per lb for the year of 1998/1999 etc. For the year 2001/2002, the actual rate charged for management fee for dyed fabrics was twice the rate stated in the Management Agreement.

87. The information set out in Table 1 was provided by the Taxpayer. The Taxpayer did not provide all the underlying debit notes. As it can be seen from Table 1, the rates of the service fees shown in the table were different from those set out in the Management Agreement.

88. The Taxpayer’s answer was that under the Management Agreement, the parties are entitled to reach mutual agreement on the rate of the service fee. Mr M said in his witness statement that the management fee was subject to yearly review.

89. The entitlement to agree to terms other than the written provision is one matter. Whether the parties had actually made other agreements to vary the Management Agreement is another matter. It is not sufficient for the Taxpayer to simply suggest that the parties were entitled to make other agreements to vary the written term of the Management Agreement. The Taxpayer has to adduce convincing evidence to prove that the parties had actually made such other agreements and the terms of such other agreements.

90. The Taxpayer produced no document in support of the existence of such other ‘agreement’. As we have remarked above, the bare assertion of the tax representatives, without more, could not be accepted as part of the evidence. We are of the view that the Taxpayer has not discharged the burden of proof in this respect by the mere production of tables showing the amount of management fees charged coupled with some underlying debit notes and the financial statements, but without evidence on who, when and how these ‘other agreements’ had been made, and what were the terms of these ‘other agreements’ that varied or supplemented the written terms of the Management Agreement.

91. In paragraph 10 of Mr M’s witness statement, he referred to the gist of the discussion at the Executive Committee meetings of E Group¹ on the fixing of the agreed rate of HK\$1.4 per lb for dyed fabrics. He stated that this was the initial rate and it was ‘to be reviewed on a yearly basis thereafter’. There was however no mention at all in his

¹ There were no particulars about these Executive Committee meetings.

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witness statement of any other agreement or review made on the rate of management fee. Further, while Mr M suggested that there was a yearly review, we note that at least in 2002, two different rates were used for different periods of the same year, suggesting that there were more one review in that year.

92. Under cross-examination, Mr M suggested on the first occasion that there was/were oral agreement(s) made on the rates of management fees. Mr M could not give any particulars about the oral agreement(s). He actually confirmed that he did not participate in the oral agreement(s). He said that he only learnt about the oral agreement(s) in the Executive Committee meetings. There was however a complete lack of particulars about these oral agreement(s), the circumstances under which Mr M heard about them, and the gist of what Mr M had heard.

93. The following is an extract of Mr M's oral testimony at the hearing in this connection:

'Q: So do you say that the parties followed the terms of the management agreement in their dealings with one another?

A: Yes.

.....

Q: Now please turn to clause 3 and read that to yourself....

.....

Q: Now this clause 3 states that the agent can charge and 'the Principal shall pay a service fee of HK\$1.40 per pound for dyed fabrics or any other rate as may be mutually agreed upon by the parties'.

A: Yes.

Q: So on this agreement, there is no agreement for the provision of service fee in respect of knitted fabric nor dyed thread, agree?

A: HK\$0.30 per pound for knitting, but it does not refer to the dyeing of thread.

Q: Now 0.30 is stated there, but it doesn't actually say it's for knitting.

A: **Maybe it is omitted.'**

(emphasis added)

94. Later, Mr M said these in cross-examination,

'Q: Please confirm that other than this management agreement, there were no other agreements, whether formal or otherwise, to record any alleged agreement for the payment by the taxpayer to Company A in respect of dyed thread.

A: **There were no written agreement, but there was/were oral agreement(s) because later on oral agreement(s) was/were added to confirm the rates.**

Q: But this was not mentioned in your witness statement.

A: Yes, it is correct.

.....

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A: Yes, I would like to elaborate on that. This part was not reflected in the witness statement because as I said, thread dyeing processes were added to the factories about a year after its formal operations under us.

.....

Q: So about a year, but not two, for example. Is that right?

A: I cannot recall exactly one or two because it is a process. We purchase the plant, and then we purchase the equipment. Can it start operation of thread dyeing after one year? I don't think so.

Q: Well, you need to help us because it is your evidence that the 'dyed thread was added to the factories about a year after the formal operation under us.' So, I just want to understand what your evidence is.

A: Yes, I want to say one year after; at least one year after.

Q: At least one year after, but say not more than two.

A: I cannot say for sure.

Q: But you need to help us, Mr M, because you are the one who introduced this concept, right. You tried to explain why there was no provision for dyed thread in this agreement by saying that the dyed thread was only added to the factories about a year after formal operations. That is your evidence. You suggested it yourself.

A: **But I was not involved in the procurement of relevant equipment. I can only recall from my memory.**

.....

A: I can only tell you that it is at least one year after we started to procure equipment and to prepare for that, but I cannot say for sure about the operations of this business.

.....

A: If I have to say, then I will say it is the middle of 1999.

.....

A: **My response is that the HK\$0.30 per pound was for knitting. And yes, to what you have said, there were no agreement on thread dyeing.**

Q: **Yes, I want to understand your evidence that there were oral agreements later added to confirm it.**

A: **Yes.**

Q: **Tell us about those.**

A: **I cannot answer your question because I did not participate in the oral agreements.**

Q: **So, how do you know about it?**

A: **I learned that from the Executive Committee meetings; they said it.**

.....

A: I do not agree to what you said that I made up this answer because Chinese society is different from overseas society; not everything was written down.

Q: But we have the management agreement.

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A: Agree.

Q: **So why didn't the parties reduce the agreement about dyed thread into writing, like in the management agreement?**

A: **I don't know about that.**

(emphasis added)

95. In re-examination, Mr M said that the equipment for the dyed threads was only installed years after the signing of Management Agreement:

'Q: You were also questioned in relation to dyed threads that there was no agreement on the rate of management fee applicable to dyed thread, remember?

A: Correct.

Q: I want to clarify that with you. Please look at this page, if you go down to the middle column which sets out the various rates over the year for the dyed threads.

A: Correct.

Q: You see that basically there's only two rates, \$0.40 or \$0.50.

A: Correct.

Q: **Now when you referred to oral agreements, were you referring to one oral agreement or several oral agreements? Or in what circumstances would those oral agreements come into place?**

.....

A: **This was talked about by the middle-level management. They talked about it. I do not have direct knowledge about that. So when we see the numbers, we asked how the fee was come about; and they said the upper management said it.'**

(emphasis added)

96. The re-examination on the point of oral agreement does not clarify or assist any further. Mr M's evidence was that the equipment was installed subsequent to the entry of the Management Agreement. This might explain why there was no mention of 'dyed thread' in the Management Agreement. However, there remains no evidence on whether the parties had agreed to the inclusion of the dyed threads in the Management Agreement, and if so, when, how, by whom and on what terms.

97. Mr M was then asked by this Board who are the 'upper management'. His answer was that *'I don't know the upper people. I think it is manager, someone with the level of Mr T.'*

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98. When he was asked by this Board who are the ‘middle level management’, he simply answered ‘*accounting people*’ and that is all.

99. The idea of ‘oral agreement’ was first introduced by Mr M in the witness box. Mr M said he learnt about it at the Executive Committee meetings. Mr M admitted that he has no personal knowledge of the oral agreement(s). He could not provide any particulars about the ‘oral agreement’ nor particulars and circumstances under which he heard these at the Executive Committee meetings.

100. With the assistance of documents referred to him by Counsel for the Taxpayer, Mr M still could not say whether there was one or more than one oral agreements. His unparticularised hearsay evidence is not reliable and not accepted. We do not accept that the Taxpayer has satisfactorily proved that there was ‘oral agreement’ made to vary the terms of the Management Agreement.

101. The unreliability of Mr M’s evidence on the contested issues in this appeal can also be found in the following areas.

101.1. When Mr M was asked whether the debit notes regarding the management fee were issued on the date stated in the debit note or backdated, Mr M admitted that he did not know.

101.2. To justify the basis of his evidence, Mr M said, ‘*But I can tell you that I have been in this Group for more than 30 years. Personnel of this Group came and went. I have been involved in some Executive Committee meetings of the Group, so I know something.*’

101.3. In his witness statement, Mr M offered to give evidence on the corporate structure of the E Group after restructuring. He adduced the corporate chart and explained in his witness statement various entities shown on the corporate chart. When he was asked about the corporate relationship, he said these in the witness box:

‘A: To my knowledge, this chart is prepared by another employee under the H Group. I am the employee of E Group. I gained access to this information in the meetings, but the preparation of this chart was done by someone else.

Q: So would it be correct that you yourself have no direct knowledge of **what is stated in this group, save that you were provided** this document during a meeting?

A: I know some, I don’t know some. So, I don’t have full direct knowledge of the whole process.

.....

Q: So do you actually know anything about the restructuring of the H Group, ‘yes’ or ‘no’?

A: I have some knowledge, but I don’t have full picture of the restructuring.’

(emphasis added)

101.4. The issuance of the \$5.4 Million Debit Note is an example of clear deviation from the written terms of the Management Agreement and is therefore an important feature in this appeal. Mr M, the Taxpayer's only witness, said these when he was cross-examined:

'Q: So a sum of 5.4 million was asked for, and the reference is 'Management Fee For the Month of 03/1998'. Do you see that?

A: Yes.

Q: But at 637, we already have the request for management fee in the month of March 1998 by reference to the amount produced multiplied by the respective unit rates. So, why do we have the situation at 638 of another request for management fees of the same month of March?

A: **This is a bonus. They used the wrong wording, it is not management fee.**

Q: **Now you said that it is actually a bonus, they just used the wrong wording, it is not the management fee.**

A: **Yes.**

Q: I need to put it to you that this feature of bonus has never been mentioned previously by you in your witness statement.

....

A: Yes, I did not mention that.

.....

Q: Now just looking at page 638, **this is a purported request for management fees wholly unrelated to the production of dyed fabrics or knitted fabrics.**

A: **Dyeing or knitting of fabrics, this is a bonus for Company A.**

.....

A: It is related to the performance of Company A.

Q: Now if look at 637, we see how the management fees for the month of March are calculated. There was a reference to the amount of pounds of knitting and amount of pounds for dyeing multiplied by the respective unit rates; and then we have the sum 4.39 odd million, right?

A: Yes.

Q: Whereas on 638, it is simply a request for 5.4 million without any reference to the production of any fabrics or any reference to any unit rates. Do you agree or disagree?

A: Yes, it is obvious. It is not about the calculation. Yes, it is very obvious that it is only a few words on this debit note.

Q: So, you agree with me.

A: Yes, agree to what you said.

Q: Thank you. Now in fact, **although it is termed 'Management Fee For the Month of 03/1998', in fact it is simply an adjustment, an accounting adjustment to book the taxpayer's profits into Company A. Would you agree or disagree with me?**

- A: **It is said very clearly that it is a management fee, and I also mentioned that it was a bonus. So, I disagree with you that it is a tax avoidance measure.**
- Q: Now, I never used the word ‘tax avoidance’. My question was, this is merely an audit adjustment to book the taxpayer’s profits into Company A. I never mentioned anything about ‘tax avoidance’.
- A: **I expressly said that it is a bonus management fee. It is not an adjustment.**
- Q: I see. So now you have a new concept of ‘bonus management fee’, right, because initially
- A: **Bonus actually refers to a lot of things. Yes, I said ‘bonus management fee’. This is a better term because everything is about bonus. It is quite general. We have performance bonus and annual bonus.**
- Q: I see. But at 12:15, you actually said the word ‘management fee’ on 638 was wrongly used. You said it wasn’t a management fee, it was actually a bonus. But now at 12:40, you are saying that the better term is ‘bonus management fee’.
- A: Yes.’
(emphasis added)

102. Mr M kept changing his evidence on the nature of this \$5.4 million.

102.1. He first said it is a ‘bonus’, and ‘not a management fee’, he even said that the ‘wrong wording’ was used in the debit note.

102.2. When it was put to Mr M that the idea of bonus never featured in the witness statement, he accepted it.

102.3. When it was then put to Mr M that the \$5.4 million was wholly unrelated to the production of dyed fabrics or knitted fabrics, Mr M said it was a bonus for Company A, and was related to the performance of Company A.

102.4. When he was further asked about the sum, Mr M said it was ‘a bonus management fee’, but not an accounting adjustment.

103. The above evidence of Mr M was in stark contradiction with the accounting records submitted by the Taxpayer in which the sum of \$4.5 million was described to be an ‘adjustment’. There is no evidence adduced by the Taxpayer to explain the meaning of ‘adjustment’ in the accounting records.

104. The concept of a payment for ‘bonus’ or ‘bonus management fee’ or ‘performance bonus’ was not found in the Management Agreement.

105. The Taxpayer’s only case was that the sums claimed for deduction are management fees paid pursuant to the Management Agreement. To justify these sums

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were made pursuant to the Management Agreement, the Taxpayer suggested that there were review or other agreements reached to vary the written terms of the Management Agreement.

106. The Taxpayer adduced no evidence from those who made or have direct knowledge about these ‘reviews’ or ‘other agreements’. The Taxpayer adduced no evidence to explain the nature of the sums which were not referable to the terms of the Management Agreement. The bare, wavering and unparticularised assertions of Mr M are not convincing and are not accepted.

107. In the written closing submission of the Taxpayer, it shifted its case and relied on ‘conduct of the parties’. In item 5 of Appendix II of the Taxpayer’s closing submission, the Taxpayer submitted that:

‘The actual conduct of the parties clearly demonstrates what rates had been **‘mutually agreed upon by the parties’** from time to time in accordance with Clause 3.’

108. The Board was presented with different versions of evidence on the nature of these sums and the basis of what the Taxpayer said these different rates were agreed. The Taxpayer chose not to call witness who has direct knowledge of the matter to give evidence. The Taxpayer attempted to prove this important piece of fact by bare assertions or evidence of unparticularised multiple hearsay. We could not infer simply from the charging of the fees by Company A and/or the payment by the Taxpayer as evidence that the parties had ‘varied’ or ‘supplemented’ the terms of the Management Agreement. The Taxpayer simply failed to prove this suggestion.

109. Therefore, insofar as such part of the Impugned Management Fees which were not made in accordance with the written terms of the Management Agreement (‘Extraneous Fees’), the Taxpayer failed to prove on a balance of probabilities that they were expenses incurred in the production of the assessable profits, and thus are not deductible under sections 16 and 17 of the Ordinance.

110. There remains the part of Impugned Management Fees that were paid in accordance with the written terms of the Management Agreement (‘Management Fees Per Written Agreement’).

111. We have decided that Company A had its operation and is not a ‘sham’ or mere ‘bookkeeping entity’. Company A had performed the tasks under the Management Agreement. The Management Fees Per Written Agreement was charged at a fix agreed rate set out in the Management Agreement. The force of the Revenue’s contention that the Management Fees were arbitrary and excessive would have more force if we are to consider the entire Management Fees claimed. The force of such argument was very much reduced insofar as the Management Fees Per Written Agreement are concerned. Having evaluated all the evidence, we are satisfied that the Management Fees Per Written Agreement are deductible expenses under sections 16 and 17 of the Ordinance.

112. Before we decide whether this case shall be remitted to the Commissioner under section 68(8)(a) of the Ordinance, we shall first deal with the Revenue's alternative claims under section 61A of the Ordinance insofar as the Management Fees Per Written Agreement is concerned.

K. Is Section 61A engaged?

Relevant legal principles

113. Section 61A is not a charging provision. It is an alternative provision to sections 16 and 17 of the Ordinance (Shui On Credit).

114. In Shui On Credit, Lord Walker NPJ answered the question left open in Ngai Lik Electronics, and held that *'a tax benefit in the statutory sense is required before s.61A is engaged, so that section can apply only to a transaction which would otherwise avoid tax.'*

115. In view of our decision on the non-deductibility of the Extraneous Fees, we will only focus on the Management Fees Per Written Agreement.

116. It is trite that the following three intersecting conditions must be satisfied before the Commissioner can exercise the power to raise an assessment under section 61A(2):

- '(a) a transaction (broadly defined to include an operation or scheme) has been entered into;*
 - (b) such transaction has, or would have had but for this section, the effect of conferring a tax benefit on the relevant person (that is, on the taxpayer against whom the section has been invoked); and*
 - (c) viewing the transaction through the prism of the seven matters enumerated in section 61A(1)(a) to (g), 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.'*
- (See: Ngai Lik Electronics [34])

117. 'Tax benefit' was defined in section 61A(3) of the Ordinance as meaning 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof'.

118. The seven specific matters enumerated in section 61A(1)(a) to (g) are as follows:

- '(a) the manner in which the transaction was entered into or carried out;*
- (b) the form and substance of the transaction;*

- (c) *the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;*
- (d) *any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;*
- (e) *any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;*
- (f) *whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and*
- (g) *the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.'*

Particulars for Section 61A

119. The particulars identified by the Revenue for the purpose of section 61A of the Ordinance as modified to apply only to the Management Fees Per Written Agreement was that: the transaction(s) which had the effect of conferring the tax benefit on the Taxpayer is the entering into of the Management Agreement pursuant to which the Taxpayer paid the Management Fees Per Written Agreement as well as each and every payment made thereunder ('**Transaction**'). The person or persons having the relevant dominant purpose is the Taxpayer and/or Company A and/or Mr C and/or Mr D.

The 3 intersecting conditions – Transaction, Tax Benefit, Sole or Dominant Purpose

120. There is no dispute that the Transaction identified satisfied the first intersecting condition.

121. The major arguments are on the other two conditions.

122. The Taxpayer relied on the following remarks of Ribeiro PJ in Ngai Lik Electronics, [101] that '*The statutory purpose of section 61A is not to attack arrangement made to secure tax benefit which are legislatively intended to be available to the taxpayer.*'

123. It contended that the Transaction is 'a legitimate arrangement to segregate certain functions related to offshore production of fabrics in the Mainland from the other functions undertaken by [the Taxpayer]'s staff in Hong Kong. The fact that this resulted in tax reduction as the profits from offshore operations are not taxable was simply the consequence of our legislative scheme which taxes profits based on the *source* of the profit-making activities'. The Taxpayer contended that the Transaction ought not fall foul of section 61A.

124. It has also been held by the Court of Final Appeal that a transaction that serves a proper commercial purpose can still be caught by section 61A as for the sole and dominant purpose of conferring a tax benefit. It is a matter of degree and facts. (FTC v

Spotless Service Ltd [1996] 186 CLR 404 at 416 High Court of Australia, cited in D25/15 (2016-17) 31 IRBRD 270; Commissioner of Inland Revenue v Tai Hing Cotton Mill Development Ltd (2007) 10 HKCFAR 704).

125. The Taxpayer's argument that the Transaction is a legitimate arrangement is tainted with Company A's non-registration of its business with the Mainland, which, as admitted by Mr M, was a contravention of the PRC laws and regulations. This would not be an arrangement intended by the legislature.

126. In Tai Hing Cotton Mill, Lord Hoffmann NPJ explained the approaches to section 61A as follows:

[13] Did the transaction have the effect of conferring a tax benefit? A benefit is something which makes your position better. The word invites a comparison.

[14] s61A raises a straightforward question of causation and comparison. If the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit. Provided that the calculation is properly done, the section is not concerned with how the elements of the calculation are categorized for other purposes of tax law.

[15] The real question is the alternative hypothesis which the comparison requires. That is a question of construction. It must be gathered from the terms of the section as a whole. ...

.....

[17] s61A(2) gives the Commissioner an option. Paragraph (a) says that she may assess the taxpayer as if the transaction had not been entered into or carried out. But she may also, under para. (b), assess the taxpayer in such other manner as she considers appropriate 'to counteract the tax benefit which would otherwise be obtained'. The hypothesis of an assessment under (b) must therefore be, not only that the actual transaction did not take place, but that some other transaction took place instead. Otherwise (b) would add nothing to (a). the effect of s.61A is that, the tax benefit does not have to relate some other pre-existing source of income, external to the transaction. The Commissioner, under a transaction which created income, but without the features which conferred the tax benefit. That makes s.61A a much more powerful and flexible weapon in the hands of the Commissioner than the New Zealand section.

*[21] In my opinion the power of **the Commissioner** under s.61A(2)(b) must be the same. She would not be entitled, as the more alarmist*

*submissions of the counsel for the taxpayer suggested, to make an assessment on the hypothesis that the taxpayer had entered into an alternative transaction which attracted the highest rate of tax. That would not be a reasonable exercise of the power. But she **may adopt the hypothesis which the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit.***

(emphasis added)

127. Lord Walker NPJ has the following observation in Shui On Credit:
'54. *The scope of the Commissioner's powers under s61A(2) is a question of statutory construction (Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd at para. 15). **The exercise of those powers is for the Commissioner's judgement, subject to public law constraints.** Of course the Commissioner must have regard to the facts as agreed or found by the Board. But any inquiry into the subjective attitudes of the Taxpayer and its associates would be inconsistent with the objective approach that is one of the essential features of s.61A.*'
128. The effect of the Transaction on the Taxpayer was that the Management Fees Per Written Agreement paid to Company A could be deducted from the Taxpayer's assessable profits, and therefore the Taxpayer has no liability to pay tax in regard to such fees.
129. The Commissioner's case is that the above should be compared with the alternative hypothesis that if Company A were not used, the Taxpayer would have done the production management work itself. The Commissioner considered that this is the only appropriate alternative hypothesis for comparison.
130. On the hypothesis that the Taxpayer will have performed the production management work itself, the Taxpayer, being a trader, cannot pay itself 'management fee' and seek to treat these as deductions under section 16. The Impugned Management Fee (which is essentially the operating profit of Company A) will be retained by the Taxpayer, result in a larger assessable profits for taxation. The Transaction, on the other hand, has the effect of passing these profits to Company A, a tax benefit was therefore conferred on the Taxpayer.
131. The Taxpayer, however, contended that the alternative hypothesis should be that: the Taxpayer would have to engage an independent third party manufacturer, and the fees that would have to pay to the third party would be higher than the current costs of the Taxpayer under the Transaction.
132. It is the Taxpayer's case that Company A was established in 1996 in accordance with the overall management philosophy decided by the H Group prior to the listing in September 1996. Prior to the establishment of Company A, there was no separate entity to provide production management services to the Taxpayer. Many of Company

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A's staff were originally employed by the Taxpayer or other entities within the Group. No outside agent had previously been used.

133. It appears that the Taxpayer was suggesting that without interposing Company A, it would have to engage third party manufacturer undertaking the tasks of not only the production management, which was performed by the Company A, but also the processing works for dyeing and knitting, which was performed by the PRC Factories. The Taxpayer did not explain why, if Company A was not interposed, it has to engage third party manufacturers instead of continuing to use the PRC Factories for the manufacturing works.

134. Further, in support of the Taxpayer's argument that the engagement of independent third party manufacturers would be more costly, the Taxpayer sought to refer to a table presented by the tax representative to the Revenue in 2008. The table is titled '*Comparison of the sub-contracting fees payable to independent third party manufacturers in the market with the dyeing processing fees and knitting processing fees paid to the PRC Factories*'. The rate said to be charged by the third party was for contract out processing work (外發加工), but not production management works done by Company A.

135. The Taxpayer has not included primary documents to support the figures stated in the table. The Taxpayer has not called any witness to adduce evidence in this respect or to explain the table. There is just no basis for this Board to come to a finding that the engagement of independent third party manufacturers in place of Company A would be more costly.

136. We do not consider it appropriate to adopt the alternative hypothesis suggested by the Taxpayer.

137. The Taxpayer further argued that even if the Revenue's alternative hypothesis is adopted, all the works done by Company A were performed in the Mainland, and are to treated as non-taxable offshore income, and therefore, the Taxpayer argued that the Transaction would not confer tax benefit on it.

138. We do not accept this argument of the Taxpayer. At all material times, the Taxpayer is a trader, and has declared its profits for taxation in Hong Kong. It has not raised a challenge that its profits were not taxable in Hong Kong by reason of them having been derived offshore.

139. This appeal is about the tax affairs of the Taxpayer, but not Company A. The evidence shows that its trading activities were carried out in Hong Kong. There is no convincing evidence to substantiate the contention that if the Taxpayer took over Company A's role, the income would have been wholly offshore.

140. In the circumstances, we consider the alternative hypothesis adopted by the Commissioner is, on the evidence before us, the most likely alternative hypothesis. By comparison, the Taxpayer's liability to tax would be lower by interposing the Transaction which enable a deduction of the Management Fees Per Written Agreement in the Taxpayer's

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assessment for tax. The Transaction thus has the effect of conferring a tax benefit on the Taxpayer, but for the operation of section 61A.

141. The next question is whether the Transaction was entered into with the sole or dominant purpose of obtaining a tax benefit. This question was not to be answered by accessing the actual or subjective purpose of the parties, but is to be viewed objectively after considering the various matters listed in paragraphs (a) to (g) of section 61A(1). (Tai Hing Cotton Mill [28])

142. As to section 61A(1)(a), viz : the manner in which the Transaction was entered into or carried out, we note the following:

- 142.1. The Management Agreement stated on its face that it was to have effect from a date before Company A existed.
- 142.2. The parties have not followed the terms of the Management Agreement, for example, on the stipulated date of the payment of the Management Fees.
- 142.3. The Taxpayer was Company A's only client.
- 142.4. The majority of Company A's staff (at least initially) had worked previously for the Taxpayer or other entities in the Group. Their job titles, duties and place of work were essentially the same before or after the transfer to Company A.
- 142.5. Company A did not file individual income tax returns in respect of its staff.
- 142.6. According to the Company H's internal document (that is the organisation chart of the restructured E Group), Company A was put under a branch called 'Offshore Profits Team' (as opposed to the 'Overseas Business Team') and all companies under that branch was incorporated in the BVI.

143. In connection with the form and substance of the Transaction (section 61A(1)(b)), we note the following:

- 143.1. The work of the Company A's staff could not be observed on contemporaneous documentary evidence, but was put, for example, in the name of the PRC Factories.
- 143.2. Company A's staff represented themselves as representatives of the PRC Factories and their name cards only bore the name of the PRC Factories.
- 143.3. The staff of Company A were primarily transferred from the Taxpayer or other entities within the Group.
- 143.4. Company A did not have a bank account for a considerable amount of time after incorporation, and had to rely on its related companies to pay staff salary.

143.5. Apart from intercompany loans, Company A had no assets nor liabilities.

143.6. The Taxpayer placed heavy reliance on the ‘assumption of risk’ by Company A under the Management Agreement to justify the high profit margins. However, its business was all from same group companies. There is unlikely that Company A would have any real risk of claims from its own related companies. The evidence also shows that it never gave rise to any liability for Company A. We do not accept the Taxpayer’s bare assertion that Company A did an excellent job and thus no claims were arisen.

144. The matter to be considered under section 61A(1)(c) is straightforward. The entering into of the Management Agreement and the payment of the Management Fees Per Written Agreement thereunder, but for section 61A, would have allowed the Taxpayer to claim deduction of such payments.

145. The change in the financial position of the Taxpayer and any person who has connection with the Taxpayer, that has resulted, will result, or may reasonably be expected to result from the Transaction (section 61A(1)(d) and (e)) is that by shifting the profits to Company A through the payment of Management Fees Per Written Agreement, this had the effect of allowing the Taxpayer to claim a deduction of expenses, and lowered its tax liability. This would improve the financial position of the Taxpayer, and its shareholders who received the profits in the form of dividends.

146. The Transaction was not entered into on an arms’ length basis. The Taxpayer was the only client of Company A and Company A’s sole source of income was the Taxpayer. Company A, a participant of the Transaction, was a corporation resident or carrying on business outside Hong Kong. These are the signposts referred to in section 61A(1) (f) and (g) that point to the existence of requisite dominant purpose.

147. Having viewed all the circumstances objectively, we concluded that the Transaction was entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit.

148. In conclusion, we find that section 61A of the Ordinance is engaged. A remittance to the Commissioner for the apportionment of expenses would be an academic exercise and is not necessary.

L. Orders

149. By reasons of the above, we dismiss this appeal and confirm the Assessments.