Case No. D5/19

Profits tax – whether amount of additional tax excessive – consultancy fee paid to a related company for purpose of the production of chargeable profits – payment pursuant to an agreement – whether the agreement entered on arm's length basis and bona fide basis – sections 16(1), 17, 17(1), 17(1)(b), 61, 68(4), 68(9) of the Inland Revenue Ordinance ('IRO')

Panel: Chui Pak Ming Norman (chairman), Chan Wan Po Paul and Lee Wong Wai Ling Winnie.

Date of hearing: 3 May 2019
Date of decision: 26 June 2019.

The Appellant was incorporated as a private company in Hong Kong. Its principal business activity was 'property investment'. During the relevant period, the Appellant held 'Property C' and 'Property D'. The directors of the Appellant were Mr J and Ms K (spouse of Mr J, 'Mrs K'). Both were appointed on 18 August 2014. Company A was also a private company in Hong Kong. At the relevant times, Company A's shareholders were Mr J and Mrs K. The directors were Mr J, Mrs K and Ms P.

In the tax return, the Appellant declared assessable profits of $2,520,352, which were arrived at after deducting, among other things, consultancy fees of $555,000 paid to Company A. It was Appellant's case that the payment of consultancy fees was made pursuant to the terms of the agreement (29 August 2014) entered between the Appellant and Company A (the 'Agreement'). The Agreement took effect from 1 October 2014 for a term of one year.

The Respondent did request further information or documents related to the consultancy fee. Yet the Appellant did not give response. In the absence of a reply, the Respondent was not satisfied that the purported payment of consultancy fee to Company A by the Appellant was incurred in the production of chargeable profits, and raises an Additional Profits Tax Assessment ('Assessment'). The Appellant objected to the Assessment for the year of assessment 2014/15 ('Year of Assessment') raised on it by the Respondent.

The Deputy Commissioner of Inland Revenue rejected the Appellant's objection and confirmed the Additional Profits Tax Assessment for the Year of Assessment in a determination on 1 November 2018 ('Determination'). Pursuant to section 66 of the IRO, The Appellant lodged an appeal against the Determination.

In the Notice of Appeal filed, the Appellant submitted that the consultancy fee actually incurred was calculated as 15% of monthly rental income collected by Company A. The said basis was in line with similar services charged to the group's companies.

Held:

1. It was Appellant's case that the consultancy fee or management fee was incurred in the production of chargeable profits. It was therefore necessary for the Board to consider the true nature of the Agreement and to consider whether such payment was incurred in the production of the Appellant's chargeable profits (D17/99, IRBRD, vol 14, 198 followed).

2. From a commercial point of view, the Agreement was short and simple. The management fee to be paid by the Appellant under the Agreement was '25% of the monthly rental collected from tenant'. The charge of 25% was high when compared with the charge of 15% which Company A imposed on other related companies for similar purpose. The documents in support of the Appellant's allegation services were provided by Company A would not improve the justification of charging management fee set at 25%. Moreover, only the amount equivalent to 15% of the monthly rental collected was allegedly paid by the Appellant to Company A. The Appellant gave the explanation that the balance of 10% was a debt due to Company A by the Appellant. Although the Appellant and Company A purportedly entered into the Agreement, the terms of the Agreement were not followed or relied on by them.

3. Other material terms were also absent in the Agreement. The Board saw that the Agreement was not prepared or negotiated seriously between the contracting parties. The Appellant and Company A were related companies. There was no evidence that 15% was a standard charge of the industry for consultancy fee. The Board found that the Agreement was not entered into by the parties on arm's length basis and bona fide basis.

4. The Board considered objectively all the surrounding circumstances of the case whether the consultancy fee charged at 25% or 15% paid by Appellant was in production of the chargeable profits. It found that the Agreement was an artificial transaction undertaken by the Appellant and Company A with the view to reducing the amount of tax payable by the Appellant. The consultancy fee in question was not qualified for deduction under section 16(1) of the IRO and was precluded from deduction under section 17(1)(b) of the IRO. Alternatively, the payment of consultancy fee under the Agreement by the Appellant to Company A should be disregarded under section 61 of the IRO (So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 followed).

Appeal dismissed.

Cases referred to:

Seramco Limited Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287;
Commissioner of Inland Revenue v Lo & Lo [1984] STC 366;
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773;
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416;
D17/99, IRBRD, vol 14, 198
D94/99, IRBRD, vol 14, 603
D1/06, (2006-07) IRBRD, vol 21, 102
D13/07, (2007-08) IRBRD, vol 22, 365

Au Yeung Sheung King of Messrs Chee Chan & Co, CPA, for the Appellant.
Lee Shun Shan and Leung Hoi Sze, for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Appellant objected to the Additional Profits Tax Assessment for the year of assessment 2014/15 raised on it by the Respondent. The Additional Profits Tax Assessment for the aforesaid year of assessment was raised consequent upon the Respondent not being satisfied that the purported payment of consultancy fee to Company A by the Appellant was incurred in the production of chargeable profits.

2. By the determination dated 1 November 2018 ('Determination'), the Deputy Commissioner of Inland Revenue ('Deputy Commissioner') rejected the Appellant's objection and confirmed the Additional Profits Tax Assessment for the aforesaid year of assessment raised on the Appellant.

3. This is an appeal lodged by the Appellant against the Determination pursuant to the provisions of section 66 of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance').

Grounds of Appeal

4. The grounds of the appeal raised by the Appellant in the Notice of Appeal filed with the Board are summarized as follows:

(a) The principal activity of the Appellant is investment holding which holds properties for long term rental income purposes. There is no staff working for the Appellant. All activities of the Appellant are handled by Company A. Company A is an estate agency and

management company that provides its services to the Appellant. Accordingly, all consultancy fees were incurred in the production of chargeable profits.

(b) Since there is no staff working for the Appellant, no income could be generated without Company A running the daily operations.

(c) Company A finds and negotiates with potential tenants, collects monthly rent, provides day-to-day services to tenants and provides accounting services to the Appellant. It also engages in other operating matters of the Appellant including keeping track of and making mortgage payments, collecting and handling mails, negotiating with auditors, company secretary and other outside parties. The consultancy services were essential in order for the Appellant to produce chargeable profits and maintain the company as a going concern.

(d) In support of the appeal, the Appellant by way of appendixes annexed debit notes issued by Company A (indicating their rental collection services provided for the Appellant), the bank-in slip, annual secretarial fee debit note and official receipt of the Appellant, a provisional tenancy agreement issued by Company A (indicating its agency service to seek potential tenants and negotiate the terms of tenancy agreements) and consultancy fee debit notes of Company A with the Statement of Grounds of Appeal filed on 29 November 2018.

(e) The Appellant paid the consultancy fees to Company A with total amounting to HK$331,500, which was actually incurred. It satisfied section 17(1)(b) of the Ordinance. The amount actually incurred was calculated as 15% of monthly rental income collected by Company A. The basis of consultancy fees at a rate of 15% was in line with similar services charged to the group's companies. The fees were subsequently revised to 25% as mutually agreed by the Appellant and Company A.

(f) In conclusion, the Appellant considered the Determination that the whole amount of HK$555,000 not being allowed as deduction is not reasonable. The Appellant considered the consultancy fees (HK$331,500) at a rate of 15% of monthly rental income collected by Company A should be allowed as a deduction.

Facts of the Appeal

5. The Appellant confirms that paragraph (1) to paragraph (12) of the 'Facts upon which the Determination was arrived at' under Section 1 of the Determination are not disputed. In the hearing, the Appellant did not call any witness to testify nor submit any documentary evidence or otherwise in support of its appeal. By reason of the

Appellant's confirmation, we find the following paragraph (1) to paragraph (12) as relevant facts of this appeal, which are reproduced from the Determination as follows:

(1) The Appellant has objected to the Additional Profits Tax Assessment for the year of assessment 2014/15 raised on it. The Appellant claims that consultancy fees should be allowed for deduction in computation of its assessable profits.

(2) (a) The Appellant was incorporated as a private company in Hong Kong on 2 December 1988. The business address of the Appellant is in District B ('the Address').

(b) In its Profits Tax return, the Appellant described its principal business activity as 'property investment'. During the relevant period, the Appellant held 'Property C' and 'Property D' in District E.

(c) At the relevant times, the Appellant's shareholders and directors were:

Name of shareholders and shareholdings

	Up to 17-08-2014	From 18-08-2014
Mr F	1 share	-
Company G	1 share	-
Company H (incorporated in the British Virgin Islands)		2 shares

Name of directors

	Date of appointment	Date of resignation
Mr J	18-08-2014	
Ms K, spouse of Mr J, ('Mrs K')	18-08-2014	
Mr L		18-08-2014
Mr M		18-08-2014
Mr N		18-08-2014
Company G		18-08-2014

(d) The Appellant changed its accounting year ended date from 31 December to 31 March during the year of assessment 2014/15. The accounting period for the year of assessment 2014/15 covered 15 months from 1 January 2014 to 31 March 2015.

(3) (a) Company A was incorporated as a private company in Hong Kong in August 1997. Its business address was at the Address.

(b) At the relevant times, Company A's shareholders were Mr J and Mrs K. The directors were Mr J, Mrs K and Ms P.

(4) (a) The Company filed Profits Tax Return for the year of assessment 2014/15 together with audited financial statements and tax computation.

(b) In the tax return, the Appellant declared assessable profits of $2,520,352, which were arrived at after deducting, among other things, consultancy fees of $555,000 paid to Company A.

(c) The Appellant's detailed income statement for the year of assessment 2014/15 showed, amongst other things, the following particulars:

	$
Rental income	4,635,534
Change in fair value of investment properties	11,250,000
	15,885,534
Less: Consultancy fees paid to Company A	555,000
Other expenses	1,041,584
	1,596,584
Profit before taxation	14,288,950

(d) The assessable profits for the year of assessment 2014/15 was computed as follows:

	$
Profit before taxation	14,288,950
Less: Commercial building allowance	518,598
Change in fair value of investment properties	11,250,000
	11,768,598
Assessable Profits	2,520,352

(5) Based on the tax return, the Assessor raised Profits Tax Assessment for the year of assessment 2014/15 on the Company:

	$
Assessable Profits [Fact (4)(b)]	2,520,352
Tax payable thereon	395,858

The Appellant did not object to the above assessment and it became final and conclusive according to section 70 of the Ordinance.

(6) The Assessor requested the Appellant to supply information and documents in respect of the consultancy fees paid to Company A [Fact (4)(c)]

(7) In the absence of a reply, the Assessor was not satisfied that the Appellant should be allowed deduction of the consultancy fees. The Assessor raised the following Additional Profits Tax Assessment for the year of assessment 2014/15:

	$
Additional Assessable Profits	555,000
Tax Payable thereon	91,575

(8) The Appellant objected to the above Profits Tax Assessment on the ground that it was excessive.

(9) In respect of the consultancy fees, the Appellant put forth the following contentions:

(a) The Appellant and Company A were related companies. Company A was an estate agency and management company. It provided agency and management services to more than 40 companies within the group.

(b) There was no staff working for the Appellant. All activities of the Appellant were handled by Company A. Company A provided the following services to the Appellant:

(i) Seeking potential tenant and negotiating the terms of tenancy agreements;

(ii) Keeping accounting records and preparing financial statements;

(iii) Collecting monthly rental from tenants;

(iv) Providing day-to-day services to tenants; and

(v) Handling all other daily operation matters including making mortgage payment and handling mails.

(c) The consultancy fees also compensated Company A’s time cost

spent on performing pre-acquisition work for the change of shareholders and directors during the year of assessment 2014/15 [Fact (2)(c)]. The pre-acquisition work included inspection of the conditions of Property C and Property D and reviewing the Appellant's historical documents.

(d) The basis of the consultancy fees was determined by negotiation. It was computed at 25% of the monthly rental income collected by Company A for the Appellant.

(e) The amount of consultancy fees for the year of assessment 2014/15 was computed as follows:

Period	Rent		Rate	Consultancy fees		Total
	Property C	Property D		Property C	Property D	
Sep 2014	130,000	185,000	25%	32,500	46,250	78,750
Oct 2014	130,000	185,000	25%	32,500	46,250	78,750
Nov 2014	130,000	185,000	25%	32,500	46,250	78,750
Dec 2014	130,000	185,000	25%	32,500	46,250	78,750
Jan 2015	135,000	185,000	25%	33,750	46,250	80,000
Feb 2015	135,000	185,000	25%	33,750	46,250	80,000
Mar 2015	135,000	185,000	25%	33,750	46,250	80,000
Total:	925,000	1,295,000	25%	231,250	323,750	555,000

(f) The Consultancy fees were settled by cheque payments as follows:

Property C

Period	Consultancy Fees	Payment Date	Payment Method	Amount Paid	Outstanding Balance
	$			$	$
Sep 2014	32,500	21-10-2014	Not available	19,500	13,000
Oct 2014	32,500	04-11-2014	Cheque	19,500	13,000
Nov 2014	32,500	02-12-2014	Cheque	19,500	13,000
Dec 2014	32,500	03-01-2015	Cheque	19,500	13,000
Jan 2015	33,750	03-02-2015	Cheque	19,500	14,250
Feb 2015	33,750	04-03-2015	Cheque	19,500	14,250
Mar 2015	33,750	02-04-2015	Cheque	20,250	13,500
Total:	231,250			137,250	94,000

Property D

Period	Consultancy Fees	Payment Date	Payment Method	Amount Paid	Outstanding balance
	$			$	$
Sept 2014	46,250	21-10-2014	Not available	27,750	18,500
Oct 2014	46,250	02-12-2014	Cheque	27,750	18,500
Nov 2014	46,250	02-12-2014	Cheque	27,750	18,500
Dec 2014	46,250	03-01-2015	Cheque	27,750	18,500
Jan 2015	46,250	03-02-2015	Cheque	27,750	18,500
Feb 2015	46,250	04-03-2015	Cheque	27,750	18,500
Mar 2015	46,250	02-04-2015	Cheque	27,750	18,500
Total:	323,750			194,250	129,500

(10) To support the claim, the Appellant provided, among other things, the following documents:

(a) A management agreement dated 29 August 2014 ('the Agreement') entered into between the Appellant and Company A. The Agreement took effect from 1 October 2014 for a term of one year.

(b) Bank statements issued by Bank Q without the name of the account holder. The bank statements showed the following cheque withdrawals:

Date	Transaction details	Amount of withdrawal
		$
04-11-2014	Cheque XXXXXX	19,500
02-12-2014	Cheque XXXXXX	75,000
03-01-2015	Cheque XXXXXX	47,250
03-02-2015	Cheque XXXXXX	47,250
04-03-2015	Cheque XXXXXX	47,250
02-04-2015	Cheque XXXXXX	48,000
	Total:	284,250

(c) Debit notes issued by Company A to the Appellant in respect of the consultancy fees:

Property C

Date	Period covered	Amount
		$
12-09-2014	01-09-2014 to 30-09-2014	32,500
25-09-2014	01-10-2014 to 31-10-2014	32,500
29-10-2014	01-11-2014 to 30-11-2014	32,500
28-11-2014	01-12-2014 to 31-12-2014	32,500
27-12-2014	01-01-2015 to 31-01-2015	33,750
28-01-2015	01-02-2015 to 28-02-2015	33,750
27-02-2015	01-03-2015 to 31-03-2015	33,750
	Total:	231,250

Property D

Date	Period covered	Amount
		$
12-09-2014	01-09-2014 to 30-09-2014	46,250
25-09-2014	01-10-2014 to 31-10-2014	46,250
29-10-2014	01-11-2014 to 30-11-2014	46,250
28-11-2014	01-12-2014 to 31-12-2014	46,250

27-12-2014	01-01-2015 to 31-01-2015	46,250
28-01-2015	01-02-2015 to 28-02-2015	46,250
27-02-2015	01-03-2015 to 31-03-2015	46,250
	Total:	323,750

(11) The Assessor requested the Appellant to provide the following further information and documents regarding the consultancy fees:

(a) A list of Company A's staff performing agency and management services to the Appellant.

(b) A list of the Appellant's tenants served by Company A.

(c) Documentary evidence such as copies of minutes of meetings and correspondence exchanged between the Appellant and Company A indicating the work done by Company A.

(d) Ledger accounts and payment records showing the balance of consultancy fees was settled.

(e) Documentary evidence indicating the consultancy fees rate of 25% was in line with the market rate for similar services.

(12) To date, no reply has been received from the Appellant.

Issues of the Appeal

6. The Board agrees with the submission of the Respondent that the issues for the Board to consider are:

(a) Whether the consultancy fee in the amount of $555,000 is deductible under section 16(1) of the Ordinance and is not precluded from deduction under section 17(1) of the Ordinance; and

(b) Whether the purported engagement of Company A by the Appellant to provide the claimed services and the alleged payment of consultancy fee by the Appellant to Company A constitute artificial transactions and should be disregarded for the purpose of section 61 of the Ordinance.

Relevant provisions of the Ordinance applicable to the Appeal

7. The following are relevant provisions of the Ordinance which are applicable to resolve the issues.

(a) Section 16(1) of the Ordinance provides *inter alia* that:

‘*in ascertaining the profits in respect of which a person is chargeable to tax under [this Part (for profits tax)] 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 profits tax)] ....*’.

(b) Section 17(1)(b) of the Ordinance provides *inter alia* that:

‘*For the purpose of ascertaining profits in respect of which a person is chargeable to tax under [this Part (for profits tax)] no deduction shall be allowed in respect of ………. any disbursements or expenses not being money expended for the purposes of producing such profits.*’

(c) Section 61 of the Ordinance provides that:

‘*Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.*’

(d) Section 68(4) of the Ordinance provides that:

‘*The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*’

(e) Section 68(9) of the Ordinance provides *inter alia* that:

‘*Where under subsection (8), the Board does not reduce or annul such assessment, the Board may order the Appellant to pay as costs of the Board a sum not exceeding the amount specified in Part 1 of Schedule 5, which shall be added to the tax charged and recovered therewith.*’

The amount specified in Part 1 of Schedule 5 is $25,000.

Authorities submitted by the parties

8. The list of authorities submitted by the Respondent, which is not disputed by the Appellant, reads as follows:

(a) Seramco Limited Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287;

(b) Commissioner of Inland Revenue v Lo & Lo [1984] STC 366;

(c) Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773;

(d) So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416;

(e) D17/99, IRBRD, vol 14, 198

(f) D94/99, IRBRD, vol 14, 603;

(g) D1/06, (2006-07) IRBRD, vol 21, 102; and

(h) D13/07, (2007-08) IRBRD, vol 22, 365

9. The Appellant did not submit any authority to support its appeal.

Submission of the Appellant

10. Mr Au-yeung, the Appellant's representative, submitted that the management fee was charged at 25% of the rental received because the directors of the Appellant thought that Company A was involved in the acquisition process of the company (Appellant) and Company A had spent a lot of time there. Although Company A charged the other companies within the group at 15% of the rental income, Company A had to charge at 25% of the rental income in order to reflect the services provided during the acquisition. To support his allegation, Mr Au-yeung referred the Board to the explanation stated in their reply letter dated 18 April 2018 to the Inland Revenue Department.

11. It is the Appellant's submission that since the Appellant employed no staff, the Appellant had to rely on others to operate its business. Company A, being a related company of the Appellant, provided the day-to-day operation services to the Appellant. In support of his argument that the Appellant employed no staff and had to rely on others to operate the day-to-day business of the Appellant, Mr Au-yeung referred the Board to the Appellant's audited account for the period from 1 January 2014 to 31 March 2015. He said the audited account did not reveal that the Appellant had payment of salary to any staff. He also referred the Board to the debit notes issued by Company A to the Appellant which indicated the fact that Company A had employed staff to provide the Appellant with the management services. The said debit notes were issued by Ms R of Company A.

12. As such, Mr Au-yeung argued strenuously that at least a portion of the management fee or consultancy fee paid by the Appellant to Company A should be allowed. He suggested that at least 15% of the rental income of the Appellant should be charged by Company A because it was in line with the percentage which Company A charged the other related companies in the Group.

Analysis and Discussion

13. As a starting point, the Board needs to consider the entitlement to claim deduction under section 16(1) of the Ordinance.

14. As per the Board of D17/99 said[1], in order to be entitled to claim deduction under section 16(1) of the Ordinance, the taxpayer had to establish that:

(a) He had incurred the expense;

(b) It was incurred during the basis period; and

(c) It was incurred in the production of chargeable profits.

15. It is not disputed that consultancy fee in the amount of $555,000 had been billed to the Appellant by Company A during the year of assessment 2014/15. It is the Appellant's case that the payment of consultancy fee or management fee was made pursuant to the terms of the Agreement[2] which was incurred in the production of chargeable profits. It is therefore necessary for the Board to consider the true nature of the Agreement and to consider whether such payment was incurred in the production of the Appellant's chargeable profits.

Essential Terms of the Agreement

16. The Agreement is consisted of 2 pages. There are 8 clauses in the Agreement. Except the boiler clauses, the most essential terms of the Agreement are as follows:

(a) Recital: The Appellant desires to engage the services of Company A to provide certain accountancy, management and administrative services.

(b) Clause 1: Company A shall provide to the Appellant the services set out below in consideration of the payments of management fee, which equal to 25% of monthly rental collected from tenant, to be mutually agreed by the parties.

(c) Clause 2: This Agreement shall be deemed to have commenced with effect from 1st October 2014 and shall continue for an initial term of 1 year thereafter (subject to the provisions for earlier termination hereinafter contained).

(d) Clause 3: The obligations and responsibilities of Company A hereunder shall be as follows:

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[1] Paragraph 19 at page 202 of IRBRD, vol 14, 198.
[2] The Management Agreement dated 29 August 2014 entered into between the Appellant and Company A.

(a) Seeking potential tenant and negotiating the terms of tenancy agreements;

(b) Keeping a set of accounting records and preparation of financial statements;

(c) Collection of monthly rental from tenant;

(d) Handling all other daily operation matters and maintain the ongoing of the Appellant.

(e) Clause 6: Notwithstanding anything contained in this Agreement to the contrary this Agreement may be terminated at any time by either party giving not less than one month's notice to that effect in writing.

Services to be provided by Company A under the Agreement

17. From a commercial point of view, the Agreement is short and simple. In gist, the Appellant engaged Company A to provide services for one year commencing on 1 October 2014. The services to be provided were consisted of 3 categories: (a) leasing of the properties owned by the Appellant; (b) accounting; and (c) daily operation service. In return, the Appellant paid a sum equal to '25% of monthly rental collected from tenant, to be mutually agreed by the parties'. We cannot get the exact meaning of this clause. If it was '25% of monthly rental collected from tenant', then there was no need 'to be mutually agreed by the parties'.

18. Anyway, from Mr Au-yeung's submission, we understand that the management fee to be paid by the Appellant under the Agreement was '25% of the monthly rental collected from tenant'. For simplicity, we use '25%' and '15%' to respectively represent 25% and 15% of the monthly rental collected from the tenants of the Appellant in this Decision.

Leasing of properties owned by the Appellant

19. Although clause 3 of the Agreement specified that Company A had to seek potential tenant and negotiate the terms of tenancy agreements, there was no information as to the properties owned by the Appellant in the Agreement. Let us set aside the percentage for a moment, the services to be provided and the income to be received by Company A would largely depend on the number and the types of properties owned by the Appellant and to be managed by Company A. We are surprised that such important information was not set out in the Agreement, which made the subject matter of the Agreement not clear enough.

20. We do not know whether the fee set at 25% was justified or not. It would be a rewarding contract for Company A if the Appellant owned, say for example, 10 properties, all of which were leased out or needed the services of Company A to lease out.

However, it might not be a rewarding contract even if it charged at 25%, if, only one property was leased out with the other 9 properties left vacant during the contractual period.

Tenants of Property C and Property D

21. The entire share capital of the Appellant was acquired by Mr J and Mrs K through Company H in August 2014. As indicated in the two debit notes dated 12 September 2014 issued by Company A to the Appellant, Company A charged the Appellant for the service fee at 25% in respect of September 2014 rental.

22. Property C was occupied by Company S and Property D was occupied by Company T in September 2014 (as indicated by the aforesaid 2 debit notes).

23. Common sense tells us that it is more probable than not that Company S and Company T were respective sitting tenants of Property C and Property D at the time when the Appellant entered into the Agreement with Company A (i.e. on or about 29 August 2014). They were not introduced or located by Company A pursuant to the terms of the Agreement because the Agreement only took effect on 1 October 2014.

24. The Appellant only held two properties, namely, Property C and Property D at the material time. There was no evidence whatsoever from the Appellant that the tenancy agreements of Property C and Property D might be terminated between 1 October 2014 and 30 September 2015 which would necessitate Company A to provide service in relation to seeking new tenants. The charge of 25% was high when compared with the charge of 15% which Company A imposed on other related companies for similar services provided. Since the service of seeking new tenants was not required due to the fact that the Property C and Property D were occupied by sitting tenants during the term of the Agreement, it made the rate of 25% evenly unreasonably high.

25. In support of the Appellant's allegation that services were actually provided by Company A, the Appellant provided the following documents:

(a) Debit note to Company S for payment of rental for December 2014;

(b) Debit note to Company T for payment of rental for November 2014;

(c) Account Deposit Form dated 5 December 2014 showing the deposit of the rentals collected from the tenants of Property C and Property D; and

(d) An undated provisional tenancy agreement in respect of Property C (the term of which commenced on 1 March 2016).

26. It should be noted that all debit notes issued to the tenants of Property C and Property D contained a request that the cheques for payment should be issued in favour of Company A. If the tenants were requested to make payment in favour of the Appellant

directly, the services to be provided by Company A in clearing the cheques and then re-depositing the proceeds into the Appellant's bank account was not necessary. The existing services provided by Company A in this regard were redundant and not necessary. In theory, it would reduce the percentage to be charged by Company A.

27. In respect of the undated provisional tenancy agreement, although it was undated, the same should be drafted sometime later than the financial year end of 2014/15 because the alleged commencement of the new term of tenancy was 1 March 2016. This undated provisional tenancy agreement was not relevant in deciding the services provided by Company A to the Appellant during the Appellant's financial year of 2014/15.

28. In our view, the documents enumerated in paragraph 25 above would not improve the justification of charging management fee set at 25%.

Accounting and Daily Operation Service

29. Clause 3(d) of the Agreement put it an obligation on Company A to handle all other daily operation and maintain the ongoing of the Appellant. From the wording of the said clause 3(d), we feel that the provision of secretarial service was one of the services to be provided by Company A to maintain the ongoing of the Appellant.

30. In support of the claim that Company A provided the daily operation service to the Appellant, the Appellant produced a debit note of Company U dated 16 December 2014 charging the Appellant for the company secretarial fee from 18 August 2014 to 17 August 2015.

31. If Company U was a company related to Company A, we do not see why Company A had to separately, through Company U, charge the Appellant. If Company U was not related to Company A, Company A should have this debit note settled out of its own costs in order to fulfil its obligation under the Agreement. The Appellant should not be asked to settle this debit note.

Was the Agreement relied on by the contracting parties?

32. Both the Agreement and the debit notes issued to the Appellant stated that the management fee (in the case of the Agreement) and the consultancy fee (in the case of the debit notes) were charged at 25%. However, only the amount equivalent to 15% of the monthly rental collected was allegedly paid by the Appellant to Company A.

33. The Appellant gave the explanation that the balance of 10% was a debt due to Company A by the Appellant. There was no evidence whatsoever that the said debt was paid by the Appellant to Company A. There was no explanation offered by the Appellant, if the same was not yet paid, why it needed to be outstanding for the past 5 years.

34. The Respondent did request further information or documents related to the consultancy fee (or management fee)[3]. Yet the Appellant did not see fit to give a response. Neither did the Appellant see fit to provide the same to the Board before nor at the hearing for its consideration.

35. Mr Au-yeung in his submission explained that the 10% represented the charge for services rendered by Company A to the Appellant for its pre-acquisition services. In our view, 'the pre-acquisition services' means the due diligence exercise to be conducted prior to the acquisition of entire share capital of the Appellant. We have to say that the Agreement did not have any provision for the Appellant to pay the 10% service fee. Even if there was such a provision, the Appellant should not be required to pay because the service of due diligence exercise was provided to Mr J and Mrs K, not the Appellant.

36. By its debit note dated 12 September 2014 issued to the Appellant, Company A charged the Appellant on the services alleged provided in September 2014. However, Company A had no duty to provide services to the Appellant and had no right to charge the Appellant because the Agreement was only in operation with effect from 1 October 2014.

37. From the above including the charge of secretarial service by Company A, it is not difficult to find that the terms of the Agreement were not followed or relied on by the Appellant and Company A although they purportedly entered into the Agreement.

Other material terms which were absent in the Agreement

38. Apart from the fact that the subject matter was not clearly mentioned in the Agreement, there were several material or essential terms missing in the Agreement, which were usual in an agreement of similar nature. One of the terms is the level of services required of from Company A. If the Appellant paid Company A so much amount of management fee for services (i.e. 25%), we would expect that the level and quality of the services required of from the service provider should be clearly provided in the agreement. The Agreement was short of those terms.

39. Manner of payment of consultancy fee is another material term in a normal commercial contract. In the Agreement, there was no provision as to the manner and time of payment of the consultancy fee payable by the Appellant.

40. Other material terms which were absent in the Agreement was the extent of authorities delegated by the Appellant to Company A and the liability on the part the Appellant or on the part of Company A to pay the third-party charges.

41. From the above we can see that the Agreement was not prepared or negotiated seriously between the contracting parties.

[3] Paragraph 5 (11) of this Decision.

42. It is not disputed that the Appellant and Company A were related companies within a group. Based on the above analysis, we are of the view that the Agreement was not entered into by the parties on arm's length basis. If they were not related companies, we doubt whether the Appellant would enter into the Agreement with Company A.

Bona fide agreement

43. It is the Appellant's argument that since the Appellant did not employ any staff, it had to engage someone else to operate its business. Following its argument, the Appellant submitted that the Appellant had a need to engage someone to provide the services and the Agreement was made for that purpose. It is their position that even if the deduction of the consultancy fee charged at 25% was not allowed, at least the Appellant was entitled to 15%, which was in line with the percentage which Company A charged on other companies within the Appellant's group companies.

44. We do not find that the argument is sound. Even if the Appellant employed no staff, it was not necessarily for the Appellant to engage Company A to provide the alleged services on the terms of the Agreement. The operation of its business was relatively simple. Mr J and Mrs K being its two directors could operate and manage the Appellant's business. There was no evidence provided by the Appellant to explain why the two directors could not undertake the operation or management of the Appellant.

45. Neither was there evidence that the Appellant had negotiated with un-related commercial companies for provision of similar services so as to show that 15% was a standard rate of charge of the industry.

46. Having examined the terms of the Agreement, we do not feel that the Agreement was made by Company A and the Appellant on arm's length basis and bona fide basis.

47. In deciding whether the consultancy fee charged at 25% or 15% paid by the Appellant was in production of the chargeable profits, the Board needs to consider objectively all the surrounding circumstances of the case. As per Chu J (as she then was) in <u>So Kai Tong v Commissioner of Inland Revenue</u> [2004] 2 HKLRD 416[4],

> '*... The objective test simply requires all circumstances to be looked at in deciding whether an item is a deductible expense. The Board may conclude that the item is or is not a deductible expense, and if it is, the extent to which it is deductible in accordance with the plain words of s.16(1).*'

48. Having considered all the aforesaid factors and all the circumstances of the case objectively and the submission made by the Appellant, the Board cannot conclude that the consultancy fee paid by the Appellant to Company A in the year of assessment 2014/15 was incurred bona fide for the purpose of producing the Appellant's chargeable

[4] At paragraph 26, Page 427.

profits for that year of assessment. The Board is of the view that the conclusion of the Agreement was an artificial transaction undertaken by the Appellant and Company A with the view to reducing the amount of tax payable by the Appellant.

49. By reason of the above, we are of the opinion that the consultancy fee in question is not qualified for deduction under section 16(1) of the Ordinance and is precluded from deduction under section 17(1)(b) of the Ordinance.

50. Alternatively, since we find that the conclusion of the Agreement was an artificial transaction for the purpose of reducing the amount of tax payable by the Appellant for the year of assessment 2014/15, the payment of consultancy fee under the Agreement by the Appellant to Company A should be disregarded under section 61 of the Ordinance.

Conclusion and Disposition of the Appeal

51. For the reasons and conclusion set out above, we dismiss the appeal and confirm the Additional Profits Tax Assessment for the year of assessment 2014/15 as confirmed by the Deputy Commissioner on 1 November 2018.