INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D96/89**

Profits tax – property rental company – whether payment of management fee excessive – sections 16(1) and 17(1) of the Inland Revenue Ordinance.

Panel: Anthony F Neoh QC (chairman), Duncan A Graham and Jorgen B Schonfeldt.

Dates of hearing: 26 and 27 July 1989.
Date of decision: 24 January 1990.

The taxpayer was a limited company which owned for rental purposes certain floors in a building. The taxpayer paid a substantial sum of money each month by way of management fees. The assessor refused to allow the management fees as a deduction of the taxpayer against the rental income. The assessor agreed that the management fee was incurred in the ordinary business of the taxpayer but maintained that it was not incurred in the production of the rental income of the taxpayer because it was excessive.

Held:

The taxpayer had failed to satisfy the Board of Review that the management fee had been incurred in earning the taxable profits of the taxpayer. However, it was accepted that the assessor had power to apportion part of the management fee and allow the same. The apportionment made by the assessor as confirmed by the Commissioner was affirmed by the Board of Review.

Appeal dismissed.

Case referred to:

Sun Life Assurance Society v Davidson and others [1958] AC 184

H Bale for the Commissioner of Inland Revenue.
Francis Eddis QC instructed by Chan & Chuk for the taxpayer.

Decision:

1. The Taxpayer has objected to the profits tax assessment raised on it for the year of assessment 1986/87. The Taxpayer claims that the assessor has incorrectly disallowed as

a deduction part of the management fees paid by the Taxpayer to its holding company ('X Company').

2. It is not in dispute that:

(a) The Taxpayer was incorporated as a private company in Hong Kong in July 1982. Its paid up capital was $10,000 and at all material times it has the same five directors, save for a corporate director who resigned in April 1984.

(b) At all material times, the Taxpayer's sole business has been the letting at a fixed rent of $114,000 per month of certain floors in an industrial building to a fellow subsidiary.

(c) In its profits tax returns, the Taxpayer reflected, inter alia, the following items in the profit and loss account:

| Period ended | Rent from fellow subsidiary $ | Management fees paid to X Company $ |
|---|---|---|
| 31-12-1982 | 532,000 | Nil |
| 31-12-1983 | 1,368,000 | Nil |
| 31-12-1984 | 1,368,000 | 60,000 |
| 31-12-1985 | 1,368,000 | 240,000 |
| 31-12-1986 | 1,368,000 | 600,000 |

(d) The assessor, on 23 December 1987, raised the following 1986/87 profits tax assessment on the Taxpayer:

| | |
|---|---|
| Basic period: | year ended 31-12-1986 |
| Profits per return: | $227,282 |
| Add: Management fee paid as excessive (600,000 – 240,000) | 360,000 |
| Assessable profits | $587,282 |
| Tax payable thereon | $108,647 |

(e) The assessor's reasons were as follows:

> ' I am of the opinion that the management fee paid, though incurred in the ordinary business of the company, is not incurred in the production of the rental income or excessive in the circumstances because in Hong Kong rental agency charges 5% to 10% of rental for management of property and rental collection services. Taking into consideration of the company's establishment, I consider $240,000 of management fee paid to the holding company as appropriate and raise an assessment as above.'

3. In a determination dated 27 June 1988, the Commissioner upheld the assessor's aforesaid assessment. Against this determination, the Taxpayer now appeals.

The Taxpayer's Case

4. In the Taxpayer's statement of grounds of appeal, submitted on 6 July 1988, it was stated that:

(a) The management fees of $600,000 charged by X Company covered all aspects of operation including rental, group strategic planning, commission, accounting, office management services and remuneration for directors' services.

(b) The management fees also represent part of the back payment of directors' remuneration for services rendered in the past years and operating charges for years ended 31 December 1982, 1983 and 1984.

(c) It has been the practice (of X Company) to charge management fees to various group companies to cover services of the directors of the parent company as well as the services listed above.

(d) Management fees paid to the parent company is based on estimated time and services required to manage the Taxpayer and also based on the estimated market value or cost or benefit required to be paid to outsiders if such value, cost or benefit were obtained from third parties.

(e) The rental charges to fellow subsidiaries are determined to reflect the market rental.

(f) The increase in payment of management fees is not made with the objective of avoiding profits tax because the parent company's fee income is subject to profits tax.

5. Mr Y, principal of a firm of certified public accountants, who was the auditor of the Taxpayer, was the only witness called to give evidence on behalf of the Taxpayer. Mr Y

produced a bundle containing documents relied on by the Taxpayer for the purpose of this appeal (hereinafter called 'the bundle').

6. In the bundle, there is a breakdown of the $600,000 management fee charged by X Company. At the Board's request, breakdowns for the 1985 and 1984 management fees were subsequently provided through solicitors for the Taxpayer. From these, the following picture emerges:

| | 1986<br>$ | 1985<br>$ | 1984<br>$ |
|---|---|---|---|
| Fees for directors emoluments | 125,000<br>(5 x 25,000) | 45,000<br>(5 x 9,000) | 21,000<br>(5 x 4,200) |
| Fees for office sharing, expenses covering staff salaries, accounting services, rent and rates, telephone, electricity and other overheads | 360,000<br>(30,000 x 12) | 195,000<br>(16,250 x 12) | 39,000<br>(3,250, x 12) |
| Fees for rental collection and commissions | 15,000 | Nil | Nil |
| Fees for provision of directors services for: | | | |
| (i) year ended 31-12-1982 | 40,000 | Nil | Nil |
| (ii) year ended 31-12-1983 | 60,000 | Nil | Nil |
| | 600,000 | 240,000 | 60,000 |

7. Mr Y admitted he had no personal knowledge of the breakdown in the bundle in respect of the 1985 management fee charged. This was provided to Mr Y by the financial controller. The breakdowns subsequently submitted to the Board bore the signature of a gentleman who described himself as chairman of the board of directors of X Company.

8. As to the basis upon which each head of the breakdown was calculated the Board received very little assistance from Mr Y. In particular:

(a) Mr Y was unable to give the Board any indication of the amount of time spent by the directors of X Company for the purpose of the Taxpayer's business notwithstanding the claim in the statement of grounds of appeal that management fees are based on estimated time and services required to manage the Taxpayer (see paragraph 4(d) above).

(b) As to the type of services that X Company's directors provided the Taxpayer, Mr Y was unable to go beyond stating that they provided 'management' and were 'looking for other opportunities'. On the other hand, Mr Y admitted that the Taxpayer at least for the time being was a property company.

(c) As to the Taxpayer's claim that the management fees were charged on a commercial basis, Mr Y did not go beyond stating that the directors of X Company charged management fees to subsidiaries according to their earnings, that there were no detailed records which verified how management fees were charged, and that X Company's directors merely guessed how much time was spent and charged accordingly.

(d) As to why the management fee for 1985 was a four fold increase over the management fee for 1984, Mr Y merely said that the whole group's overhead had increased and the directors had spent more time. As to the increase in the group's overheads, Mr Y drew attention to the increase in the group's overheads from $5,000,000 in 1984, to $7,500,000 in 1985, and to $12,100,000 in 1986. When asked by Mr Bale on behalf of the Revenue as to why the management fee had increased 400% whereas the group overheads had only increased 50%, Mr Y merely stated that it was up to the management to decide how much to charge and as he was not running the company, he could not assist.

(e) As to why the fees charged by X Company to the Taxpayer ostensibly for 'directors' emoluments' in the breakdown from 1986 were not in fact shown in the 1986 employer's return of X Company and therefore were presumably not paid, Mr Y merely said that X Company makes up its own mind as to how much it wanted to charge, thereby not answering the question at all.

(f) As to why the Taxpayer had not increased rents over the last five and a half years, Mr Y said that he could not assist and that one would have to ask the chairman.

(g) Although he was the auditor, for the accounting years ended 31 December 1982 and 31 December 1983, he could not tell how the directors' fees for X Company were compiled for those years. Further, when asked he offered no

explanation as to why the directors' fees for these two years were not charge in the accounts for the relevant years.

(h) Notwithstanding the Taxpayer's claim that the fees charged by X Company represented market value, no market evidence was adduced by Mr Y. Thus, the only market evidence available to the Board was that provided by the assessor, namely, that the level of property management and rental collection services was 5% to 10% of the rental income. This evidence, Mr Y did not seek to contradict.

9. Mr Y produced no documentation either in the form of a written contract or minutes of meetings setting out the terms of any agreement between the Taxpayer and X Company in defining the scope of management services provided. In response to a request by the Board during the last day of hearing, solicitors for the Taxpayer wrote to the secretary of the board indicating that they have been instructed by the Taxpayer that there are no directors' minutes regarding the approval of the management fees charged by X Company to its subsidiaries for the year ended 31 December 1986.

10. Mr Eddis, QC, who appeared for the Taxpayer, urged a number of arguments upon the Board. We have considered and found all his arguments to merit and indeed, they did command, our closest consideration. For the purpose of this decision, however, we hope that he would not consider us discourteous if we were to merely summarise his principal arguments which were:

(a) that the term 'management fee' should receive the widest construction (Sun Life Assurance Society v Davidson and others [1958] AC 184);

(b) that it was up to the Taxpayer's management to set within reasonable bounds the amount of management fees paid;

(c) that management decisions cannot be slavishly related to income or time sheets or vouchers and debit notes, they should only be responsible choices;

(d) that the Revenue was accordingly meddling in corporate affairs when it considered the management fee excessive. If the Revenue were allowed to substitute its own subjective opinion for the amount of fees chargeable, assessments would be at the whim of an assessor, resulting in inconsistencies in assessments.

The Revenue's Case

11. We were much assisted by a very helpful and able submission and a cross-examination of Mr Y by Mr Bale for the Revenue. It will be apparent from the latter parts of this decision that we have found his submissions helpful. For the moment, we feel

that we should highlight some of the more significant aspects of the case put forward by the Revenue:

(a) that the Taxpayer's business was a simple one: it owned certain floors of an industrial building which it leased for a fixed rent of $114,000 per month from July 1982 to December 1987, a period of sixty-five months. The only other business conducted by the Taxpayer was the purchase and sale of a public company shares resulting in profits in 1984 and 1985. The business operations of the Taxpayer were therefore simple and passive;

(b) that the Taxpayer's claim that the rental and management fee was charged according to commercial reality was not made out, in that:

(i) As to the rental, rents of flatted factory in the area in question according to the Property Review of the Rating and Valuation Department (admission into evidence of which was not objected to by Mr Eddis) have increased from $32.2 per square metre in December 1983 to $52.6 per square metre in December 1987, yet there has been no rent review by the Taxpayer.

(ii) As to the management fee, X Company's group turnover was $585,543,000, whilst the Taxpayer's turnover was $1,368,000, which was about 0.2% of the total group turnover. Yet the management fee charged to the Taxpayer represented 9.6% of the total management fees charged to all subsidiaries, contrary to Mr Y's explanation that the directors of X Company charged subsidiaries according to their earnings (see paragraph 8(c) above).

(iii) No evidence was adduced as to the following:

(1) How the total management and marketing fees ($6,248,000) were computed.

(2) The basis for the apportionment between group companies, considering their different nature of business.

(3) Details of the services provided by the holding company and its directors with regard to rental, group strategic planning, commission, accounting, office management services, director remuneration, share investment and other activities not specified in the appeal statement.

(4) Why no fees were charged in 1982/83 and 1983/84.

(5) Why the fees increased so dramatically when rental income remained unchanged. The fees increased from $60,000 in 1984/85 to $600,000 in 1986/87.

(6) Details of the actual duties, responsibilities, etc of each director in respect of the management of the Taxpayer.

(7) Reasons why the rental income was not increased.

(8) Copies of relevant directors' minutes.

(c) that the Taxpayer had accordingly failed to discharge that onus imposed upon it by section 68(4) of the Inland Revenue Ordinance of proving that the assessment appealed against was excessive or incorrect.

Conclusion

12. It is for the Taxpayer wishing to claim a deduction from profits tax to bring himself within the provisions of section 16 of the Inland Revenue Ordinance ('the Ordinance').

13. Section 16(1) of the Ordinance states:

'16(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, including –'

(The Board's underlining)

14. As to the management fee of $600,000, the Taxpayer would have to show by credible evidence that payment of this sum of money to X Company had been incurred in the production of the profit of $227,282, before the Taxpayer can claim the deduction provide for in section 16(1). Failure to do so for any part of this sum would by virtue of 17(1) preclude the deduction of such part from allowance. Section 17(1) states:

'17(1) For the purposes of ascertaining profits in respect of which a person is chargeable to tax under this part no deduction shall be allowed in respect of –

(a) domestic or private expenses, including the cost of travelling between residence and place of business;

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

(c) any expenditure of a capital nature or any loss or withdrawal of capital;

…'

(The Board's underlining)

15. Against the fact that the Taxpayer was at all material times involved in a simple business, namely the letting of certain floors in an industrial building to a fellow subsidiary, the amount of management services needed to produce the rental income could not be substantial. We accept, however, Mr Eddis's argument that the monetary value of such service is for the management of the Taxpayer and the provider of such services to decide. If the Taxpayer had decided to accept expensive services, it is its prerogative. Whoever is paid for those services will have to be taxed under the relevant provisions of the Ordinance. However, the matter does not stop there. It is for the Taxpayer to prove that the money had been used in the production of the profits.

16. The Taxpayer has to show that the whole of the $600,000 management fee has been expended in the production of the rental income, that being the only business, for the time being, of the Taxpayer. In this regard, it is the Taxpayer's case that the monetary value of the management services provided to produce the income was fixed in accordance with commercial norms, namely, the estimated market value or cost or benefit required to be paid to an outsider if he were to provide the same services. As we cannot see how an outsider could command a market rate of $600,000 for managing a company which only has to collect rent for a single letting, bringing in $1,368,000 per year (this would be equivalent to a management fee of over 40% of the Taxpayer's income when for equivalent work we are told by the assessor that agencies charge 5% to 10%), we are driven to the conclusion that only part of the $600,000 could have been used in the production of the Taxpayer's profits.

17. We have also searched in vain in Mr Y's evidence for anything which could give us a basis to find that the whole of the $600,000 was spent in the production of the Taxpayer's sole source of income. As we have recorded in paragraph 8 above, Mr Y was not able to give much assistance as to the basis for each of the heads of the breakdown for any of the years ended 31 December 1984, 1985 and 1986. Thus we are left with no evidence on which we could satisfy ourselves as to whether, and if so, which part of the fee paid for the services described under each head of the breakdown had been incurred in the production of the Taxpayer's rental income.

18. We are thus left with the position whereby the assessor (supported by the Commissioner) has conceded that $240,000 had been expended in the production of the profits. To succeed in the appeal the Taxpayer will have to show that the remainder had been expanded in the production of the profits. We regret that the Taxpayer had failed to

satisfy us as to this and in particular we refer to the omission in the evidence of the matters referred to in paragraph 11(b)(iii) above.

19. We must next consider whether the assessor had been right in apportioning the $600,000 management fee in the manner he did.

20. As the Taxpayer had failed to satisfy the assessor (as it has also failed to satisfy us) that the whole of the $600,000 management fee had been incurred in the production of the profits, the strict view could be taken that it was up to the Taxpayer to give full particulars of the services performed and the amounts charged to enable an objective determination to be undertaken. Here the Taxpayer had failed to provide any particulars save the breakdowns set out at paragraph 6 above. As we have stated, these breakdowns gave us no assistance as to which part of the fee charged by X Company for the services purported to have been rendered were incurred in the production of the Taxpayer's profits. The assessor (and we believe we should do the same) has adopted a pragmatic stand and apportioned the $600,000 in the light of his statement, which we see no reason to disagree with, that agencies charge 5% to 10% for management of property and rental collection services and in the light of all, the circumstances of the case.

21. Rule 2A(2) of the Inland Revenue Rules states:

> ' 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 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.'

22. We believe that the assessor's apportionment had been the most reasonable and appropriate in the circumstances of this case bearing in mind the following considerations:

(a) Between 1984 and 1985, there had already been a 400% increase in the management fee, whereas, the group's overheads only increased 50%. No explanation was forthcoming from the Taxpayer as to the reason for this drastic increase.

(b) In the light of Mr Y's evidence to the effect that the directors of X Company charge subsidiaries in accordance with their income (paragraph 8(c) above), the Taxpayer's contribution in 1986 to group income was 0.2%. The $600,000 management fee representing 9.6% of the group's total management fees charged to subsidiaries in that year is not commensurate with the Taxpayer's contribution to group turnover.

(c) The fees for directors' emoluments were never paid to the directors.

(d) It is also worth noting that for 1984, when there were six directors until April that year, the breakdown for that year had referred to five directors only (see paragraph 6 above). We are not satisfied that such fees were incurred for the stated purpose of management of the Taxpayer.

(d) No reason was given as to why an additional $15,000 rent collection fee should have been levied when none was levied in earlier years.

(e) There was no explanation as to why the fees for directors' services for the years ended 31 December 1982 and 1983 were not paid in those years. This provided us with no confidence and we are thus not satisfied that they were in fact incurred for the stated purpose of provision of directors' services in the years 1982 and 1983.

(f) The rise in group overheads from $7,500,000 in 1985 to $12,100,000 in 1986 would merit some increase in the management fee but in the light of the unexplained matters set out in (a) to (f) above and in the light of the fact that we were provided no basis upon which we could tell which services were in fact provided for the production of the Taxpayer's income, we are left with no choice but to adopt, doing the best we can in the circumstances, the assessor's figure for the reasons given by the assessor.

23. Finally, the Board feels that had the Taxpayer been prepared to provide the Board with full particulars of the scope of the services provided and their relationship with the production of the income, the Board may have been able to come to a different conclusion. Further, had the Taxpayer had the foresight to document the agreement between itself and its parent as to the precise scope of the services provided, it may have been able to obviate this appeal which, regrettably we cannot see our way to allow.