DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 24 (REVISED)

PROFITS TAX

SERVICE COMPANY “TYPE II” ARRANGEMENTS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department’s interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in August 1995.

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Commissioner of Inland Revenue

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INTRODUCTION

The Financial Secretary announced in his 1994-95 Budget Speech that the Administration proposed to take steps to deal with the tax avoidance aspects of certain “service company arrangements”. Two types of arrangements were identified as causing particular concern. The first (Type I cases) amount to disguised employment arrangements where the remuneration for services rendered by a person under employment-like conditions is paid not as salary to that person, but as a consultancy fee to a service company he controls. The second (Type II cases) typically involve deductions being claimed by an unincorporated business for payments, often described as management fees, which are made to a company or a trust (service company) controlled by the proprietor or partners of the business.

2. Following the announcement, consultations were held with a number of practitioners and professional groups with a view to ascertaining the most appropriate way to address the areas of concern. Having considered the advice received, the Administration introduced section 9A to the Inland Revenue Ordinance (“the Ordinance”) to curb Type I arrangements. Departmental Interpretation and Practice Notes No. 25 discuss the application of the relevant provisions which were introduced following the enactment of the Inland Revenue (Amendment) (No. 2) Ordinance 1995.

3. With regard to Type II arrangements, it was decided that in the first instance legislation would not be required. Rather, the Department should seek to discourage abuse by both explaining in a Practice Note the circumstances under which service company claims will be challenged by placing greater reliance on the general anti-avoidance provisions of the Ordinance. Accordingly, the purpose of this Practice Note is to set out the Department’s position in relation to the application of the present terms of the law to Type II arrangements.

TYPE II ARRANGEMENTS

4. As indicated at the beginning of this Practice Note, a Type II arrangement usually involves an agreement (service company agreement) under which management fees are paid by a firm to a service company directly
or indirectly controlled by the proprietor or partners of the firm. As consideration for the fees paid, the agreement generally provides for the service company to supply certain operating requirements to the firm.

5. It has become apparent to the Department that many arrangements of this kind are directed at reducing the overall incidence of tax. If the amount paid to the service company is allowed as a deduction and exceeds the cost that would have been incurred if it had directly obtained the requirements in question, the assessable profits of the firm will be reduced. The service company in turn will normally seek to avoid or minimise exposure to tax on the excess payment by claiming deductions for tax efficient remuneration provided to connected parties (e.g. the proprietor or partners of the firm or their relatives) as employees or directors of the service company.

LEGAL PRINCIPLES

6. It has been accepted in other tax jurisdictions that where a commercially realistic sum is paid under a service company arrangement for a service essential to the conduct of a firm’s business, the presumption is raised that the expenditure was for business purposes and is a genuine cost of earning the firm’s income (i.e. incurred in the production of its profits). However, it has also been recognised that the converse will apply if the expenditure is excessive, namely that the payment was not wholly for the services provided, but for some other purpose. This thinking is considered by the Department to be equally applicable to management fee claims under the Ordinance and accordingly it underlies the Department’s position in relation to such claims.

7. It follows that it is recognised there may be valid commercial reasons for the owners of an unincorporated business to make use of a service company arrangement. However, what has caused concern to the Department in recent times has been the increase in the number of arrangements encountered where, having regard to the services involved, the fees paid have been well in excess of commercially realistic amounts and, therefore, by implication, are not incurred wholly in the production of chargeable profits. Equally disturbing have been the cases where agreements have not been reduced into writing; accounts have not been properly kept; or fees have been decided on an arbitrary basis bearing little, if any, relationship to the cost of the services provided.
8. It is apparent that there is a lack of appreciation on the part of some practitioners and taxpayers of the options open to the Department to challenge service company arrangements where they fail to operate on a proper commercial basis. In this regard it should be noted that the decisions of the Board of Review in Case No. D19/99 14 IRBRD 209 and D153/01 17 IRBRD 189, both of which involved inflated management fees, provide clear illustrations of circumstances under which, by virtue of section 16(1) of the Ordinance, a management fee can be dissected and that part which is not attributable to the production of chargeable profits disallowed. Support for this view can be found in the observations of the Board in D19/99 -

At page 218

“a. Section 16

Section 16 ascertains the chargeable profits by defining which outgoings and expenses are deductible from the chargeable profits of a taxpayer. Section 16(1) allows to ‘be deducted all outgoings and expenses to the extent to which they are incurred during the basis period ... in the production of profits in respect of which he is chargeable to tax under this Part for any period including...’ Section 16(1) then sets out those expenses which are deductible.”

And at page 226

“20. D61/91, IRBRD, vol 6, 457 and D32/93, IRBRD, vol 8, 261 cited by the Revenue did not deal with section 61 and the question of artificial or fictitious transaction. Nor did Case D32/94, IRBRD, vol 9, 97 in which the taxpayer, a medical practitioner, admitted that section 61 applied to his case in order to avoid the dire consequence of the board disallowing the management fee in total as the Board was of the view that on the evidence of that case the management fee was indivisible. Although the Board in D110/98, IRBRD, vol 13, 553 cited to us mentioned on the side that the wording of section 61 does not allow the Revenue to disregard a part of a transaction, we are of the view that if service company arrangement is to be disregarded in accordance with section 61, then it is open to the Revenue to assess the chargeable profits of a
taxpayer by totally ignoring service company and the service fees. With service company and service company arrangement out of the way (in other words, after lifting the corporate veil), it is open to the Revenue to dissect the outgoing expenses of service company as if such outgoing or expenses were that of a taxpayer in the light of whether such outgoing or expenses were deductible to the extent to which they are incurred in the production of a taxpayer’s chargeable profits.”

9. Taxpayers should also be mindful of the view expressed by the Board of Review in Case No. D153/01 17 IRBRD 189 and D85/02 17 IRBRD 1017 to the effect that it may be appropriate to disallow entirely an excessive management fee which is not capable of being split into its component parts. In D153/01, at page 205, the Board said -

“53. Whether an expense is an allowable expense is governed by sections 16 and 17 of the IRO. Section 16(1) permits deduction of all outgoings and expenses which satisfy two criteria, namely (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period of the year of assessment in question. Section 17 disallows deduction of certain types of outgoings and expenses. If a taxpayer fails to prove that an expense was incurred for the production of his assessable profits, the whole of that expense will be disallowed. In the present case, if the Taxpayer is unable to prove that the management fees were incurred in the production of his assessable profits, the whole of these management fees would be disallowed. But if an expense is capable of analysis and subdivision or where section 61 or section 61A applies which allows dissection of the expenses, then that expense can be allowed ‘to the extent’ that it was incurred to produce the taxable profits and the balance thereof be disallowed. In the present case, since the management fees were made up of those expenses as detailed in Company B’s profit and loss accounts plus a mark-up of 5%, they are thus capable of analysis and subdivision. Accordingly, only those expenses which are proved to be incurred in production of the Taxpayer’s assessable profits would qualify as allowable deductions.”

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“56. We were asked by Counsel for the Taxpayer to decide on the question of whether a minute examination of Company B’s expenses was permissible under the circumstances. We decide that we should allow an examination of Company B’s expenses in detail. The amounts of management fees were calculated by reference to all the expenses and outgoings incurred by Company B in providing the requisite services plus a mark-up of 5%. Examination of those expenses and outgoings is necessary as to determine whether they were incurred in production of the Taxpayer’s assessable profits. In so doing, we are not lifting the corporate veil nor are we saying that the Taxpayer is not free to decide his own affairs but the question of whether an expense is deductible in law when computing the chargeable profits must be answered objectively. We must look into the purpose of the payments and see whether the expense was bona fide incurred in production of the chargeable profits. The onus is on the Taxpayer to show that each of those items of expenses in Company B’s profits and loss accounts was bona fide incurred for the production of his assessable profits. We are not persuaded by Counsel for the Taxpayer that since Company B’s tax position was not in dispute, the expenses in Company B’s accounts were the least relevant. Nor do we accept the contention that once the Taxpayer could establish that the management fees were incurred for the purpose of acquiring professional services from Company B, the management fees should be allowed in full. The matter does not stop there. The Taxpayer is still required to prove that the expenses were bona fide incurred for production of his assessable profits.”

10. The view expressed by the Board on the above occasion may well be regard as reflecting the principle stated in an earlier management fee case, “It is for the Taxpayer to prove that the money had been used in the production of the profits” [D96/89 6 IRBRD 372].

11. The relationship, if any, of the management fee to the services provided is also clearly an important consideration in relation to the question of whether there is a commercial rationale for a service company arrangement. In this regard, the Board observed in Case No. D110/98 13 IRBRD 553 at page 558 -
“7. In conclusion, while it is clear that some of the expenses of Company X did relate to the Taxpayer’s practice, the interposing of Company X was in reality predominantly designed to be a tax vehicle whereby a lot of the Taxpayer’s personal expenses were to be made tax deductible and, more importantly, to enable the Taxpayer to reduce his tax liability to minuscule proportions. It was hardly necessary nor even advantageous for the Taxpayer to engage Company X to provide services to his practice and certainly not at the management fee that company charged. To put it another way, if Company X was not owned by the Taxpayer and not providing him with the benefits it did (including loans on generous terms), we would not have thought there would be much if any possibility that the Taxpayer would have engaged that company. It would simply not have been commercially acceptable. Lastly, it should be noted that Company X acted only for the Taxpayer; it had no other clients.”

12. The Board in fact held in Case No. D94/99 14 IRBRD 603 that the relationship between the taxpayer and the service company was artificial and largely, if not totally, fictitious and therefore should be disregarded under the provisions of section 61 of the Ordinance. In reaching its conclusion the Board emphasised the need for the parties involved to act on an arm’s length basis if a service company arrangement is to be acceptable. At page 611 the Board stated -

“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 answered 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 us to the conclusion that the amount is wholly arbitrary, lacking in commercial reality, and thus not bona fide incurred.

26. In this case, the Taxpayer has given us very little information as to how the service fee was incurred in the production of profits. The consultancy agreement referred to ‘firstly’ a fee $12,000 every month. There is no explanation as to how this came to be increased to $1,391,200 for the relevant period. The minutes of Company D’s board is, quite apart from the discrepancies pointed out by the Revenue, totally silent as to the reasons for the substantial increase. We do not accept the contention in the Taxpayer’s letter of 2 July 1996 that the fee was agreed on an arm’s length basis. There is no explanation as to how the fees were determined ‘periodically’ as stated in that letter. The schedule, which is annexed hereto as Appendix B and relied upon by Mr B, shows irregular payments and is again totally unexplained. There is no information as to how these payments relate to services provided by Company D. It looks more like a list of sole proprietor’s drawings from his own business. There is no attempt to justify any of the sums by reference to the service provided by Company D. In the circumstances, the Taxpayer failed to discharge his onus, we have no hesitation in dismissing the appeal.”

13. It should also be noted that apart from the possibility of applying section 61 where a service company arrangement is not operated on a commercial basis, the Department may also turn to section 61A if it is apparent that the sole or dominant purpose of the arrangement is to obtain a tax benefit. In such circumstances the existence of the service company could be disregarded and the tax benefit effectively cancelled. The decision of the Board of Review in Case No. D153/01 17 IRBRD 189 is an example where the Commissioner has applied section 61A to a Type II service company arrangement. The Board accepted the Commissioner’s views and stated at page 209 -
“As to section 61A, we also accept the Commissioner’s reasons in his determination to conclude that the Service Agreement and the Employment Agreement were entered into by the Taxpayer and Company B for the sole and dominant purpose of enabling the Taxpayer to obtain a tax benefit.”

ACCEPTABLE ARRANGEMENTS

14. The following paragraphs set out the minimum requirements that must be satisfied to support a management fee claim and also spell out the basis on which the quantum of the deductible amount can generally be determined.

*Arm’s length basis*

15. There may well be circumstances which warrant a person carrying on a trade, profession or business entering into an arrangement with a properly constituted service company to obtain certain services and facilities which are required in order for the person to derive chargeable profits. However, for tax purposes, it must be emphasised that where such an arrangement is entered into, the service company has to function as a separate business operating on an arm’s length basis in its dealings with the firm. To support and be consistent with the separate status of each party, their respective rights and obligations and dealings with each other should be fully documented. Such documentation should include -

- the agreement under which the services are provided (it should specify the relevant services, the basis on which fees are to be paid, the period covered by the agreement, etc);
- minutes of meetings recording approval of the terms of the service company agreement and any subsequent amendment;
- invoices and receipts in respect of transactions between the parties;
- working papers in respect of the calculation of the fees charged by the service company;
• bank records in respect of each party; and
• employment contracts in respect of persons employed by each party.

16. In the generality of cases, where a management fee is paid to a service company on an arm’s length basis, the amount involved should reflect the costs of the service company which are directly attributable to the relevant services (e.g. salary paid to a typist) plus an appropriate mark-up to provide for the operating expenses (e.g. rent of premises occupied by the service company itself) and reasonable profit margin of the company. These matters are further discussed in the following paragraphs.

Qualifying services

17. In order to determine the deductible amount, if any, in respect of a management fee paid by a firm, the starting point must be to examine the nature of the services received from the service company. In this regard, it is necessary to identify what might, for convenience, be called “qualifying services” required by the firm in order to produce chargeable profits.

18. The Department’s position is that, broadly, the term “qualifying services” encompasses non-professional services which are required to provide the infrastructure in which the firm operates and to cater for its day-to-day operations. Accordingly, it can include services such as the provision of premises, staff (e.g. administrative, secretarial, clerical and cleaning staff), plant and equipment and miscellaneous supplies (i.e. stationery, photocopying, medical, etc). The term does not, however, extend to the provision of any services to a firm by its proprietor or partners as employees of a service company. In the latter regard, the position of the Department reflects the view that such an arrangement would in substance amount to the proprietor or partners seeking to employ themselves and therefore, on established principles, it would not be effective for taxation purposes.

19. Also excluded from the term are services performed by other professional “fee-earners” who have contracts of employment with a service company, whether or not they also hold positions as ordinary employees or salaried partners with the firm. It is pertinent in this regard that where
professionals are employed by the service company instead of the firm, it would generally be possible for the parties concerned to arrange for the service company to directly charge the client for the relevant services. In these circumstances the deduction allowed in respect of remuneration of the professionals against the sum received would be limited to the amount actually paid. Accordingly, it is not considered that any mark-up could be justified in commercial terms in respect of the portion of a management fee relating to such remuneration where the firm bills the client even though the service company employs the professionals.

20. A reference to professionals in this context should be read as applying to persons whose day-to-day duties require them to apply expertise they have acquired through training or experience in the profession of the party for whom the duties are performed. On the other hand, the term does not refer to a person who has expertise in a profession but performs only non-fee-earning services. For example, it should not be taken as applying to an accountant who carries out administrative functions in a medical practice or to a legally qualified person acting only as an office manager or librarian in a firm of solicitors.

21. It should be noted that the Department does not accept that a professional can “wear two hats” so that what might be called administrative duties are isolated from professional duties for the purpose of treating the former as qualifying services. The position of the Department in this regard is that, irrespective of whether the person concerned is a proprietor, partner or employee of the firm, such administrative duties are part and parcel of the requirements of a professional position and do not warrant separate consideration.

**Deduction allowable**

22. If a deduction is to be allowed, a firm must establish that the amount claimed in respect of each qualifying service falls within section 16 of the Ordinance and is not excluded under section 17. To establish deductibility, it must provide the Department with a detailed statement which lists the qualifying services obtained from the service company. The statement should include in respect of each service -
an explanation, unless the reason is self-evident, of why the service is required by the firm in order to produce its chargeable profits;

the amount included in the management fee claim in respect of the particular service (any portion applicable to non-business use should be excluded); and

an explanation of why the amount should be accepted as being commercially realistic and deductible.

23. As was mentioned in paragraph 16 above, the Department accepts that a commercially realistic figure for a firm to pay for qualifying services can reflect not only the costs of the service company which are directly attributable to providing the relevant services (the “cost element”), but also an appropriate margin or “mark-up” to cover the overheads and profits of the service company. It follows that to establish the deductibility of a management fee paid for qualifying services, a firm will need to provide the Department with details of how the amount claimed has been calculated. In this regard, the Department will accept that for a particular year of assessment the cost element is represented by the sum of the tax deductions, including depreciation allowances, claimable by the service company in the same year of assessment in respect of expenditure which is directly attributable to the provision of the qualifying services. As such, it should not include any amount in respect of expenditure which would not have qualified for a deduction or given rise to a depreciation allowance if it had been incurred by the firm itself, instead of by the service company, in order to obtain directly the relevant services.

24. As it is not accepted that qualifying services can include any function performed by a proprietor or partner of a firm, expenditure on any remuneration or benefits provided by a service company to such a person (e.g. as a director’s fee) must not be reflected in the computation of the cost element of qualifying services. Attached as Annex A is a simple example illustrating the adjustment required where expenditure on the provision of remuneration to a connected party is involved.

25. Where a service is provided which is used partly for a qualifying purpose and partly for some other purpose, the cost element should be reduced
to reflect the non-business application. For example, if an item of plant provided by a service company to a firm is only used by the latter 40% for business purposes, only that percentage of any depreciation allowance and related expenses should be included in the cost calculation. Similarly, where funds are borrowed by a service company in order to provide qualifying services to a firm and for some other purpose (e.g. to purchase a property occupied by a connected party), only that part of the interest which relates to the provision of the qualifying services should be included in the cost element.

26. In relation to the question of what is an appropriate mark-up, provided that the overall claim does not exceed the expenditure actually incurred, a margin not exceeding 12.5% of the cost element will generally be accepted as being commercially realistic. It is considered that a margin of this order provides a reasonable approximation of those applicable in arm’s length business operations and reflects the views expressed by the Board of Review in Case No. D94/99 14 IRBRD 603.

27. Where the information provided by a taxpayer is insufficient to establish that the deduction claimed in respect of a management fee is commercially realistic, the presumption will arise that the fee was paid at least in part for a purpose unrelated to the production of chargeable profits. In such a case, a deduction will be denied to the extent to the amount in excess of a commercially realistic figure, provided that it can be ascertained or reasonably estimated. If this is not possible, consideration will be given to disallowing the claim in toto in accordance with the view expressed by the Board of Review in Case No. D153/01 17 IRBRD 189.

**Returns and accounting**

28. Unless there are exceptional reasons for doing otherwise, a firm and its related service company should make up their accounts to the same date. If different dates are used, a detailed explanation of the underlying reasons should be provided, otherwise it may be presumed that the parties are seeking to obtain a tax benefit. It will also facilitate the assessment of a management fee claim in respect of qualifying services, if copies of the accounts of a service company and its Profits Tax computation are lodged with the Profits Tax return of the firm.
29. An assessment which in the absence of this Practice Note would have been regarded as final and conclusive in terms of section 70 of the Ordinance will not be reopened for the purpose of adjusting a management fee claim to reflect this Practice Note. However, where an assessment has not been made for any year, including a back-year, the Department will be at liberty to apply this Practice Note.

30. Moreover, it must be stressed that this Practice Note only states the Department’s practice in determining whether or not management fee paid by an unincorporated business is deductible. It has no application to the taxation of the service company. As confirmed by the Board of Review in Case No. D62/01 16 IRBRD 537 at page 555, “…The whole tenor of DIPN No 24 is on the question of whether or not the management fee paid or payable by an unincorporated business to a service company can be allowed as a deduction in the unincorporated business’ tax file. It does not deal with the chargeability of the management fee paid or payable, to a service company in the service company’s tax file…” . Whether a sum is deductible to the taxpayer does not affect its chargeability in the hands of the recipient.
Annex A

**Professional Firm**

Professional Fees  $5,000,000

Less: Management Fee for services
  (i.e. office accommodation and general clerical support) provided  4,000,000

Profits per accounts  $1,000,000

*Actual cost of providing operating requirements (i.e. office accommodation and general clerical support) by Service Company to Professional Firm -- $3,000,000*

**Computation of Assessable Profits of Professional Firm**

Profits per accounts  $1,000,000

Add: Management Fee adjustment
  (deduction restricted to $3,375,000 being actual cost of $3m + 12.5%)  625,000

Adjusted Assessable Profits  $1,625,000

*Note:* The 12.5% mark-up is on expenditure incurred by the Service Company in providing services to the Professional Firm (i.e. the “cost element”). For this purpose it is only accepted as including expenditure which would have been deductible to the Professional Firm if it had directly incurred the relevant expenditure (see Para. 23 of the Practice Note).
Service Company

Income (Management Fee) $4,000,000

Less:
Cost of services provided to Professional Firm -
    Office Accommodation,
    Administrative, Secretarial &
    General Clerical support $3,000,000
Director/Employee remuneration (connected parties) 400,000
Own Operating Expenses 200,000 3,600,000

Assessable Profits $400,000

Note: Remuneration paid to each director/employee of the Company is deductible if it falls within section 16 of the Ordinance and is not excluded under section 17. The Practice Note does not seek to provide any guidelines in respect of such claims