Management fees: Is there a tax risk?

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Management fees *per se* are not problematic or targeted by specific rules from a tax perspective. Some arrangements that are often labelled as 'management services' however hold significant risk for taxpayers. A recent tax court case provided a good example of some of these risks. This article provides a brief overview of that case followed by a broader analysis of tax risks that may arise from management fees.

Managers who advise and manage the affairs of others, for example, their investments or businesses, often charge management fees for those services. This is not unusual or out of the ordinary. In a tax context, certain arrangements that are labelled as management services are however perceived as questionable and hold risk for the taxpayers involved. A case in the KZN tax court (Case No 35448) demonstrated some of these risks. This article reviews the management fee element of the case and considers further aspects of management fees that taxpayers should be cautious about.

Tax court case

It is apparent from reading the judgment that there were serious concerns raised about the quality of evidence provided by the taxpayer throughout the course of the dispute. This includes how information was reported in tax returns, which seem to result in double deductions being claimed. These factors may well have contributed substantially to the failure of taxpayer's appeal. Despite this, the case is arguably a good example to demonstrate some risks that attach to charges labelled as management fees.

The taxpayer, a close corporation involved in the construction of low cost housing, claimed a deduction for management fees of approximately R16,7 million. It paid these fees to two related entities. The taxpayer indicated that the services provided by these entities related to the maintenance, repairs and provision of vehicles to transport labourers between construction sites. The judgment suggests that the information provided to SARS by the taxpayer at various stages and the witness' testimony was unclear and inconsistent as to the exact services that each related entity performed in exchange for the fees paid to them and the flow of funds. The court dismissed the taxpayer's appeal. It appears that this was based on a combination the taxpayer being unable to prove that it actually incurred the expenditure and also failing to demonstrate what the services were or why it should be allowed as deductions. In short, it appears as if the taxpayer failed to discharge the burden of proving that it was entitled to a deduction under section 11*(a)* of the Income Tax Act

Risks relating to management fees

Management fees *per se* are not problematic or targeted by specific rules from a tax perspective.

Arrangements that shift amounts between various taxpayers, often related parties, without any underlying service or benefit for which the payor pays are problematic, whether they are labelled as management services or something else. These arrangements are highly unlikely to pass the requirement for deductibility that the expense, if it has actually been incurred, should be attached to the performance of a business operation *bona fide* performed for the purpose of earning income from the taxpayer's trade. The non-deductibility of expenditure by the payor does not impact the taxability of amounts that the recipient received or that accrued to it. The taxpayer may have similar difficulties deducting input tax on these fees.

In instances that involve identifiable services or benefit for the payor, the complexities are likely to be more intricate. The question may arise whether the fees are commensurate to the service or benefits received, especially if paid to related parties. If they are not, this may raise red flags:

- Excessive expenditure may not be deductible in terms of section 11*(a)*.
- Depending on the overall circumstances, the charges may be susceptible to challenge under the GAAR.
- In a cross-border context the fees may be subject to transfer pricing adjustments.

Depending on the circumstances and overall purpose of the fee or service arrangement, these agreements may also bring section 103(2) into the equation if entered into mainly to move taxable profits to related entities who find themselves in tax loss positions.

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