Case No. D34/13

Salaries tax – housing benefits – appellant entering into tenancy agreements to rent property owned by company controlled by spouse – rental paid by housing benefits – whether genuine landlord and tenant relationship – whether transaction artificial and fictitious – whether transaction conferring tax benefit on appellant – section 15 of the Stamp Duty Ordinance (Chapter 117) – sections 8, 9, 61, 61A and 68 of the Inland Revenue Ordinance (Chapter 112) ('IRO').

Panel: Horace Wong Yuk Lun SC (chairman), Fu Mee Yuk Shirley and Vincent P C Kwan.

Date of hearing: 3 July 2009.
Date of decision: 24 January 2014.

The Appellant was an employee with remuneration package including basic salary, bonus and housing benefits of rental. In the event the rental exceeded the amount allowed, the employer would pay the total rental and deduct the difference from the Appellant's monthly salary; if the rental was less than the amount allowed, the Appellant would receive the balance in cash allowance.

At the relevant financial years, the Appellant resided with his wife at a property ('Property') which was acquired by a company ('Company') to which the Appellant's wife (but not the Appellant) was the majority shareholder and a director, pursuant to 4 tenancy agreements (among which 3 of them were not stamped). Rentals were purportedly paid by the Appellant to the Company under the tenancy agreements. The Appellant also obtained annual rental refund under the housing benefits of his remuneration package.

The Commissioner found that: (i) the purported lettings of the Property and the purported payment of rentals during the relevant financial years artificial and fictitious; (ii) the annual rental refund was income from the Appellant's employment; (iii) if necessary, the tax benefit obtained by the Appellant would have to be counteracted. The Appellant appealed against the Commissioner's decision, claiming that certain sums received by him from his employers were refunds of rent and should not be charged to salaries tax.

Held:

<u>Whether there was a genuine landlord/tenant relationship</u>

1. The burden rested on the Appellant to prove that the sums were truly rental refunds within the meaning of the IRO. In order to do so, it was necessary for

the Appellant to prove that there existed a genuine landlord and tenant relationship between him and the Company in respect of the lease of the Property during the relevant time.

2. Whilst the three unstamped tenancy agreements were not admissible as evidence, the failure to stamp the tenancy agreements manifested an intention not to treat them as binding legal agreements to be carried out according to its terms. The terms of these three tenancy agreements were also inconsistent and contradictory. (D78/03, IRBRD, vol 18, 801 considered)

3. The payments of 'rentals' made by Appellant did not tally well with monthly rentals purportedly payable under the tenancy agreements. The cheque payments made by the Appellant were usually made a few days before the mortgage loan instalments were due. The Board also bore in mind the close relationship between the Appellant and the Company. The Appellant had failed to discharge his burden in proving that there existed a genuine tenancy agreement between him and the Company.

Artificial or fictitious transaction

4. A fictitious transaction was one which those who were ostensibly the parties to it never intended should be carried out. (Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287, Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773, D77/99, IRBRD, vol 14, 528 and D105/00, IRBRD, vol 15, 897 considered)

5. Evidence showed that the purported lettings of the Property and the purported payments of rental were artificial or fictitious. For example, the purported rental of the Property was kept constant throughout the years, when the rateable value of the Property had been falling continuously; the Appellant had also been paying the Company much more than he was obliged to pay under the tenancy agreements.

Section 61A of the IRO

6. Section 61A should apply only if the transaction had 'the effect of conferring a tax benefit on a person'. A benefit was something which made one's position better. If the effect of the transaction was that one's liability to tax was less than it would have been on some other appropriate hypothesis, one had a tax benefit. (Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704, Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717 and Ngai Lik Electronic Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296 considered)

7. In considering the 7 matters listed in paragraphs (a) to (g) of section 61A, the matters have to be considered objectively and globally. (Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704 and Yick Fung Estates Ltd v Commissioner of Inland Revenue [2000] 1 HKLRD 381 considered)

8. On the objective facts, the sole or dominant purpose of the making of the tenancy agreements and the purported payments of rentals thereunder was to enable the Appellant to obtain a tax benefit.

Appeal dismissed.

Cases referred to:

Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773
D77/99, IRBRD, vol 14, 528
D105/00, IRBRD, vol 15, 897
Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704
Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717
Ngai Lik Electronic Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296
Yick Fung Estates Ltd v Commissioner of Inland Revenue [2000] 1 HKLRD 381
D78/03, IRBRD, vol 18, 801

Chang Wai Hang from A & C Business Consultants Limited for the Appellant.
Cham Shum Mei and Lau Wai Sum for the Commissioner of Inland Revenue.

Decision:

Appeal

1. Mr A ('the Taxpayer') appealed against the determination of the Deputy Commissioner of Inland Revenue ('the Commissioner') dated 4 February 2009 ('the Determination') on the years of assessment 1998/1999, 1999/2000, 2000/01, 2002/03 and 2003/04 raised on him. The Taxpayer claims that certain sums received by him from his employers were refunds of rent and should not be charged to salaries tax.

Background Facts

2. The Taxpayer was married to Ms B ('the Wife'). At all relevant times, the Taxpayer and the Wife (collectively referred to as 'the Couple') resided at Flat C ('the Subject Property').

3. The Subject Property, which has a floor area of 1,137 square feet, was acquired by Company D on 2 November 1992. Company D was a private company incorporated in Hong Kong in August 1992. The issued and paid up share capital of Company D was 10,000 shares of $1 each. At all relevant times, the Wife and Ms E held 9,999 shares and 1 share respectively in Company D. They were the only two directors of the company. The Taxpayer is not a director of Company D.

4. After Company D had acquired the Subject Property in November 1992, Company D started to lease the Subject Property to the Taxpayer. The Taxpayer and his family then moved into the Subject Property at around the same time.

5. By an appointment letter dated 25 November 1993 issued by Company F, the Taxpayer was employed as the Vice President, China Affairs of the China Department with effect from 1 November 1993. The remuneration package provided to the Taxpayer included a basic salary, bonus and the following housing benefits:

> ' The Company will pay your rent up to HK$25,000 per month. The costs of utilities, telephones, household insurance and other household expenditure are for your own account. In the event of your rental exceeding the amount referred to above, then the Company will pay your total rental and deduct the difference from your monthly salary. However, if your rent is less than the above, you will receive the balance in cash allowance.'

6. It is clear that the Taxpayer is entitled to claim housing benefits (and hence enjoy the rental refunds) regardless of the identity of the landlord.

7. The Taxpayer's employment was subsequently transferred within the Company F group. Insofar as relevant and during the years of assessment from 1998/99 to 2003/04, the Taxpayer was employed successively by Company F1, Company F2, Company F3 and Company F4, which are collectively referred to hereinafter as 'the Employers'.

8. As far as the housing benefits are concerned, the Taxpayer's housing benefit entitlement remained unchanged before 1 March 2002. From 1 March 2002 onwards, the Taxpayer's Housing and Passage Benefits were increased to $40,350 per month payable in arrears. However, the actual housing benefits conferred upon the Taxpayer prior to 1 March 2002 were:

Year of Assessment	Housing Benefits
1998 – 1999	$549,000
1999 – 2000	$500,980
2000 – 2001	$466,680
2002 – 2003	$484,200
2003 – 2004	$484,200

9. The Employers filed employer's returns in respect of the Taxpayer for the years of assessment 1998/99 to 2003/04. In the years in which the additional salaries tax assessments were disputed, the Employers recorded that the rental paid by, and the rent refund made to, the Taxpayer was $468,000 for each year, or $39,000 per month.

10. The rentals paid by the Taxpayer were purportedly made pursuant to the terms of a number of tenancy agreements signed between the Taxpayer and Company D, as follows:

(1) For the period 1 December 1997 to 30 November 1999. This agreement was not stamped (the '1997 Agreement');

(2) For the period 1 December 1999 to 30 November 2001. This agreement was not stamped (the '1999 Agreement');

(3) For the period 1 December 2001 to 30 November 2003. This agreement was not stamped (the '2001 Agreement');

(4) For the period 1 April 2001 to 30 March 2004. The tenancy agreement was purportedly signed on 25 February 2003, and was stamped on the next day (the '2003 Agreement').

11. It may be noted that parts of the period from 1 April 2001 to 30 November 2003 are covered by the 1999 Agreement, the 2001 Agreement and the 2003 Agreement with overlaps in between.

12. On 2 November 1992, Company D obtained a mortgage loan from Bank G with the Subject Property as security. This mortgage was repaid on 7 September 1999.

13. The mortgage of the Bank G was apparently replaced by another mortgage from Bank H, dated 7 September 1999, by which Company D mortgaged the Subject Property to Bank G for 'general banking facilities'. In a 'Supplemental Sheet for Mortgage Loan Application Form' signed by the Taxpayer, he purported to describe his relationship with Company D as its 'director'. The Taxpayer also executed a personal guarantee in favour of Bank G for the facilities to be extended to Company D. The Mortgage Loan Application Form, which was not signed by the Taxpayer, purported to state the use of the Subject Property was 'owner-occupied'. The Bank G mortgage was subsequently redeemed and discharged on 6 September 2003.

14. According to the Employers, the Taxpayer was required to submit tenancy agreements in support of his claim for housing benefits before the end of each fiscal year. However, the housing benefits were paid to the Taxpayer's bank account each month before the Taxpayer submitted the tenancy agreements at the end of the fiscal year.

15. In response to the Assessor's enquiries in respect of loans by the Taxpayer to Company D:

(a) Company D initially confirmed that it had obtained loans from the Taxpayer.

(b) Company D later asserted that 'in substance the money deposited to our Company by [the Taxpayer] in excess of the rental was not a loan to the Company but a loan on behalf of our director. Hence the transactions were recorded under the account "Amount due to directors" in the ledger account.'

16. In response to the Assessor's request, the Employers supplied, among other things, copies of the Taxpayer's Claim For Tax Deduction on Rental/Travel Expenses in respect of the years ended 31 March 1999, 2000, 2001, 2003 and 2004.

17. The following facts were further ascertained by the Assessor:

(a) Company D received the following advances from director, which were unsecured, interest free and had no fixed repayment term:

As at	Amount due to director
31.03.1998	$3,632,120
31.03.1999	$3,976,283
31.03.2000	$5,038,237
31.03.2001	$5,907,775
31.03.2002	$6,272,430
31.03.2003	$6,672,678
31.03.2004	$6,785,297

(b) During the years of assessment 1998/99 to 2003/04, Company D either sustained tax losses or reduced its assessable profits by tax loss brought forward.

The Determination

18. In his Determination, the Deputy Commissioner found that the purported lettings of the Subject Property by Company D to the Taxpayer and the purported payments made by the Taxpayer to Company D during the relevant years of assessment

('the Impugned Transactions') are 'artificial or fictitious' transactions under section 61 of the Inland Revenue Ordinance (Chapter 112) (the 'Ordinance'):

> ' In the context of section 61 of the Ordinance, the impugned transaction in the present case involves the renting of the Subject Property by the Taxpayer from [Company D] .... The Taxpayer and/or the Wife advanced substantial monies to [Company D] .... Yet the Couple did not charge any interest or obtained any other return from these advances ... As the Subject Property was owned by the Wife (indirectly though), it is reasonable that the Taxpayer needed not pay any rent before he could live at it. Quite to the contrary, the Taxpayer had to pay substantial rent to [Company D] to rent it back. It was commercially unrealistic for the Taxpayer not to receive any interest from the monies advanced to [Company D] and for him to pay rent to [Company D] before he could live at the Subject Property. By purportedly renting the Subject Property from [Company D] and claiming rent refunds from the Employers..., the Taxpayer would not be liable to salaries tax in respect of a substantial portion of his employment income. Furthermore, there is no suggestion or evidence that [Company D] has paid any tax in respect of the rental income received from the Taxpayer. Most probably, such rental income was absorbed by mortgage loan interest and other expenses in relation to the Subject Property as well as the tax loss brought forward by [Company D] ... Such expenses would not otherwise be deductible if the Taxpayer and [Company D] had not entered into the transaction. It is clear that the transaction reduced or would reduce the amount of tax payable by the Taxpayer.'

19. The Deputy Commissioner disregarded the Impugned Transactions, and treated the annual rental refund of $468,000 as income from the Taxpayer's employment (under section 9(1)(a) of the Ordinance).

20. By the Determination, the Deputy Commissioner determined that additional salaries tax assessments be raised with the Taxpayer.

21. As the Deputy Commissioner reached the conclusion based on section 61 of the Ordinance, he did not consider it necessary to apply section 61A of the Ordinance. He pointed out that, 'if necessary', he would have concluded that section 61A of the Ordinance also applied and that the tax benefit obtained by the Taxpayer would have to be counteracted under that section. No specific reasons, however, were given for this conclusion that the Deputy Commissioner stated that he 'would have' made.

22. On behalf of the Taxpayer, A & C Business Consultants Limited ('the Representative') objected to the additional salaries tax assessments on the following grounds:

(a) The additional income assessed were indeed rental refunds which were deemed not to be assessable income under section 9(1A) of the Ordinance.

(b) The Taxpayer was provided with housing benefit as clearly stated in his employment contract during all the subject years of assessment. During these years, he did pay actual rental to the landlord as consideration for occupying the property as his residence.

Issues in the Appeal

23. The issues in the present appeal are:

(1) Whether there existed a genuine landlord and tenant relationship between Company D and the Taxpayer;

(2) Whether the Taxpayer has discharged his onus in proving that the additional salaries tax assessments were excessive or incorrect;

(3) Whether the Impugned Transactions are 'artificial or fictitious' within the meaning of section 61 of the Ordinance;

(4) Whether the Impugned Transactions have, or would have had but for section 61A of the Ordinance, the effect of conferring a tax benefit on the Taxpayer; and whether the Impugned Transactions were entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit; and

(5) Whether the Impugned Transactions should be disregarded for the purpose of assessing the Taxpayer's salaries tax for the years of assessment in question, or treated as if the same or any part thereof had not been entered into or carried out, or in such other manner as the Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.

The Law

The relevant Statutory Provisions

24. The relevant provisions of the Ordinance are set out below:

<u>Section 8</u>

' *(1) Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his*

income arising in or derived from Hong Kong from the following sources-

(a) any office or employment of profit …'

Section 9

' (1) Income from any office or employment includes-

(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others, …

(b) the rental value of any place of residence provided rent-free by the employer or an associated corporation; …

(1A) (a) Notwithstanding subsection (1)(a), where an employer or an associated corporation-

(i) pays all or part of the rent payable by the employee; or

(ii) refunds all or part of the rent paid by the employee,

such payment or refund shall be deemed not to be income;

(b) a place of residence in respect of which an employer or associated corporation has paid or refunded all the rent therefor shall be deemed for the purposes of subsection (1) to be provided rent free by the employer or associated corporation; …

(2) The rental value of any place of residence provided by the employer or an associated corporation shall be deemed to be 10% of the income as described in subsection (1)(a) derived from the employer for the period during which a place of residence is provided after deducing the outgoings, expenses and allowances provided for in section 12(1)(a) and (b) to the extent to which they are incurred during the period for which the place of residence is provided …'

Section 61

' 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.'

Section 61A

‘ *(1) This section shall apply where … that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as ‘the relevant person’), and, having regard to-*

(a) the manner in which the transaction was entered into or carried out;

(b) the form and substance of the transaction;

(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;

(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;

(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;

(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm’s length under a transaction of the kind in question; and

(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,

it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

(2) Where subsection (1) applies, the powers conferred upon an assessor under Part 10 shall be exercised by an assistant commissioner, and such assistant commissioner shall, without derogation from the powers which he may exercise under that Part, assess the liability to tax of the relevant person-

> *(a) as if the transaction or any part thereof had not been entered into or carried out; or*
>
> *(b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.'*

Section 68

> ' *(4) The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

25. Section 15 of the Stamp Duty Ordinance (Chapter 117) further provides that:

> ' *… no instrument chargeable with stamp duty shall be received in evidence in any proceedings whatsoever except-*
>
> *(a) criminal proceedings;*
>
> *(b) civil proceedings by the Collector to recover stamp duty or any penalty payable under the Ordinance,*
>
> *or be available for any other purposes whatsoever, unless such instrument is duly stamped.*'

Assessment of income and rental refunds

26. It is clear from the provisions of section 9 of the Ordinance that if the sums in question (i.e. the alleged rental refunds) are in the nature of salaries or cash allowances, they are fully assessable as the Taxpayer's income under section 9(1)(a) of the Ordinance. On the other hand, if they are truly rent refunds, section 9(1A)(a)(ii) of the Ordinance has the effect of deeming such refunds not to be income. The Taxpayer should instead be assessed for the place of residence provided by the employer at a rental value in accordance with sections 9(1)(b), 9(1A) and 9(2) of the Ordinance (with the rental value deemed to be 10% of the income).

27. By virtue of section 68 of the Ordinance, the onus rests upon the Taxpayer to prove that the assessments appealed against are excessive or incorrect. Hence the burden rests on the Taxpayer to prove that the sums in question were truly rent refunds within the meaning of section 9(1A) of the Ordinance. In order to prove that, it is necessary for the Taxpayer to prove that there existed a genuine landlord and tenant relationship between him and Company D in respect of the lease of the Subject Property during the relevant years of assessment.

Meaning of 'Artificial' and 'Fictitious' in section 61 of the Ordinance

28. In Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287 ('Seramco'), Lord Diplock stated at 298A to 298D:

> ' *"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious." A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial"' within the ordinary meaning of that word.*' (underline added)

29. The aforesaid judgment in Seramco was cited by our Court of Appeal, with approval, in Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773, paragraph 40, per Woo JA.

30. In D77/99, IRBRD, vol 14, 528 at paragraphs 33(d) and (e), this Board held that a transaction is not artificial merely because the transaction is one between related parties, even if it is intended for tax planning purpose.

31. As Lord Diplock held in Seramco, a fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. This meaning of 'fictitious' was adopted by the Board in D105/00, IRBRD, vol 15, 897, where the Board stated, at page 911, paragraph 50:

> ' *the tenancy agreement or the letting was fictitious because the parties did not intend to be bound by the terms thereof.*'

Meaning of Conferring a Tax Benefit in section 61A of the Ordinance

32. Section 61A of the Ordinance shall apply only if the transaction has 'the effect of conferring a tax benefit on a person'. Thus, it is necessary to understand the meaning of the phrase 'conferring a tax benefit'. This was explained by Lord Hoffman NPJ in Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd (2007) 10

HKCFAR 704 ('Tai Hing Cotton Mill'), at paragraphs 13 to 15:

> '*13. Did the transaction have the effect of conferring a tax benefit? A benefit is something which makes your position better. The word invites a comparison. But what do you compare with what? …*
>
> *14. … In my opinion however, s.61A raises a straightforward question of causation and comparison. If the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit. Provided that the calculation is properly done, the section is not concerned with how the elements of the calculation are categorised for other purposes of tax law.*
>
> *15. The real question is the alternative hypothesis which the comparison requires. That is a question of construction. It must be gathered from the terms of the section as a whole. Section 61A is what is called in the trade a general anti-avoidance rule. It applies generally to any method of avoiding any tax...'* (emphasis added)

33. In Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717, at paragraphs 17 to 18, Lord Hoffman NPJ described a 'tax benefit' in the following terms:

> '*17. … A tax benefit simply means a difference favourbale to the taxpayer between his tax liability computed on one basis and his liability computed on a different basis. It does not mean any particular element in that computation.*
>
> *18. … In my opinion a transaction with terms or features which reduce the taxpayer's liability, compared with what it would have been without them, confers a tax benefit upon him….*'

34. Further guidance on the interpretation of section 61A of the Ordinance can be found in Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 296, at paragraphs 34 to 36, 99, per Ribeiro PJ:

> '*34. Three intersecting conditions must be satisfied before the Commissioner can exercise her power to raise an assessment under s.61A(2). They are that:*
>
> *(a) a transaction (broadly defined to include an operation or scheme) has been entered into;*
>
> *(b) such transaction has, or would have had but for this section, the effect of conferring a tax benefit on the relevant person (that is, on*

the taxpayer against whom the section has been invoked); and

(c) viewing the transaction through the prism of the seven matters enumerated in s.61A(1)(a) to (g), it would objectively be concluded that it was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

35. If s.61A is to be applied, it is essential to identify with some precision what the tax benefit allegedly conferred (or which would, but for the section be conferred) on the taxpayer consists of. Only then can one confidently identify the transaction, if any, which has the effect of conferring that tax benefit on him. And only then is one able to examine that transaction in the light of the seven specified matters to determine whether its sole or dominant purpose is to enable the taxpayer to obtain a tax benefit.

36. It will be necessary later to consider the meaning of 'tax benefit' as defined in s.61A(3). However, for present purposes, the point to be emphasised is that the three interlocking conditions – transaction, tax benefit and dominant purpose – must be properly aligned and approached with the necessary degree of precision if the application of s.61A is not to miscarry.

…

99. Certain preliminary comments may be made in relation to the matters listed in s.61A(1)(a) to (g) (set out in Section C above).

(a) It appears to me that there is a qualitative difference between the first three items and the four remaining matters. The matters in paras.(a), (b) and (c) give guidance on methodology – guidance as to how the facts are to be approached in addressing the question of dominant purpose; while paras.(d)-(g) point to certain classes of fact as possible signposts to the requisite dominant purpose.

(b) Thus, para.(a) tells us that it is permissible to look at the genesis of the transaction and also at the actual manner of its implementation. We are not confined simply to the features of the scheme itself or simply to its terms as set out on paper.

(c) Paragraph (b) indicates that one is entitled to look beyond the form and at the substance of the transaction, making it plain, for instance, that approaches such as that of Lord Tomlin in IRC v Duke of Westminster, confining the court to the legal forms has no

place in the s.61A regime. This was a point made by the High Court of Australia in the context of similar Australian legislation in Commissioner of Taxation of the Commonwealth of Australia v Spotless Services Limited. Clearly, para.(b) overlaps with the other paragraphs as one is in each case looking at the substance and not just the form of the relevant arrangement.

(d) *Paragraph (c) requires the fiscal effects of the overall transaction to be assessed, a matter closely overlapping with the anterior requirement of being satisfied that the scheme had the effect of conferring a tax benefit on the taxpayer.*

(e) *Paragraphs (d) and (e) require us to look at the financial effects of the particular scheme on the taxpayer and also on persons connected with the taxpayer, such as the group to which a taxpayer company belongs. It may be highly significant under para.(d) that the scheme brings about no changes to the taxpayer's financial position while at the same time producing a tax benefit. Or, under para.(e), it may be significant that the scheme involves transactions among group members resulting in an unchanged financial position for the group as a whole but in the conferment of a tax benefit on the taxpayer. As Lord Nolan pointed out in IRC v Willoughby:*

> *"The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option."*

(f) *Similarly, the fact that the scheme incorporates dealings which are not at arm's length may (as para (f) indicates) be an important signpost since commercial dealings are normally conducted at arm's length and the uncommercial features of a transaction may suggest that it was entered into with the dominant purpose of producing a tax benefit for the taxpayer.*

(g) *The participation of an offshore corporation in the transaction (mentioned in para.(g)) might be a pointer to the requisite dominant purpose because it may indicate an attempt to exploit for tax avoidance purposes, the source requirement in the*

charging provisions of s.14.' (underline added)

Sole or Dominant Purpose

35. The words used in section 61A, namely, having regard to the matters set out in section 61A(1)(a) to (g), '*it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person… to obtain a tax benefit*' strongly suggests an objective approach. That this is so is confirmed by the Court of Final Appeal in the Tai Hing Cotton Mill case, where Lord Hoffmann observed, at paragraph 28:

> ' *The question in s.61A is not what the purpose of the parties actually was, but the objective question of what would be concluded from a consideration of the various matters listed in paras (a) to (g)…*'

36. In considering the 7 matters listed in paragraphs (a) to (g) of section 61A, the matters have to be considered globally. In Yick Fung Estates Ltd v Commissioner of Inland Revenue [2000] 1 HKLRD 381, Rogers JA (as he then was) held as follows, at 399B to I:

> ' *There is no, and has, as far as can be seen, been no, dispute between the parties that the words '… it would be concluded that…' and indeed, the structure of sub-s.(1) lead to the conclusion that the tests set out in s.61A have to be applied objectively.*
>
> …
>
> *In this Court, there was some discussion as to whether it is necessary for more than one item in matters (a) to (g) to indicate the sole or dominant purpose for it to be possible that that conclusion be arrived at. In my view, the posing of the question itself possibly indicates an erroneous approach to the section. Clearly, what must happen is that those matters must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit. It may be observed, for example, that one or other of the matters in (a) to (g) may be strongly or weakly suggestive of a purpose of obtaining a tax benefit or may be strongly or weakly suggestive of some other purpose. The Assistant Commissioner who undertakes such task has to use his own common sense and apply the results of his deliberations in respect of such matter and come to an overall conclusion.*' (underline added)

The Evidence

37. The Taxpayer is the only witness giving evidence at the hearing of the Appeal. His evidence is relatively short. We would highlight some aspects of his evidence insofar as

they are relevant to our consideration of the issues in the present case.

38. On the question of the lack of stamping of the 1997 Agreement, the 1999 Agreement and the 2001 Agreement, the Taxpayer explained that he was not concerned with the matter of stamping of the tenancy agreements; that was a matter, according to him, of carelessness on the part of his wife. When asked why the 2003 Agreement was stamped, the Taxpayer told us that since the 1999 Agreement and the 2001 Agreement were not stamped, the period of letting provided in the 2003 Agreement was dated back to 1 April 2001 in order to ensure that the relevant period was covered by stamp duty. He was, however, unable to tell us why the period of the 2003 Agreement did not extend back to 1 December 1999, if the intention was to cover the tenancy period of the 1999 Agreement for which stamp duty had not been paid. We must say that we find the Taxpayer's explanation in this regard rather unsatisfactory.

39. When it was pointed out to the Taxpayer that although the 2003 Agreement covered a period that overlapped with that under the 1999 Agreement and the 2001 Agreement, the terms of the 2003 Agreement were different from those of the other 2 agreements (e.g. while the 2003 Agreement provided for a break clause which allowed the Taxpayer to terminate the tenancy after 24 months – i.e. after 31 March 2003, there was no such break clause in the 2001 Agreement, which means that the Taxpayer would have been contractually obliged to rent the Subject Property for the full lease period up to 30 November 2003), the Taxpayer's explanation was that the terms of the tenancy agreements were different because the tenancy agreements were based on standardized tenancy agreements bought from shops.

40. During his evidence the question was explored with the Taxpayer on why the amounts of the cheque payments deposited into Company D's bank account were often much more than the supposed monthly rentals. Although the monthly rental was supposed to be $39,000 per month, the amount of the payments into Company D's account was often greater than the amount of the rental – with amounts often exceeding $50,000 or even more. The Taxpayer told us that he sometimes made cheque payments to Company D for over $39,000 per month because parts of these payments were to assist his wife in her business.

41. The Commissioner's representative pointed out that the Taxpayer only paid rent of $30,000 in April 2000. The Taxpayer's bank savings at that time was substantially over $39,000. The Taxpayer explained that $9,000 had been prepaid in the month before. However, the Taxpayer was unable to provide any evidence to show that Company D was aware that $9,000 had been prepaid, nor could he explain why there was such a prepayment made. Company D's balance sheet as at 31 March 2000 did not record any prepayment of rental by the Taxpayer in the sum of $9,000.

42. The amounts of many of the cheque payments made by the Taxpayer (particularly those made before 2001) did not match with the amounts of the deposits into the Company D's bank accounts (even if the payments and deposits were made on the same day). This suggests that many of the Taxpayer's cheques, said to be made for rental

payments, were not in fact directly deposited into Company D's bank account. In his evidence, the Taxpayer accepted that some of the cheques were drawn in favour of his wife, not Company D.

43. The Taxpayer was cross-examined on the rental receipts issued by Company D for the rentals paid by him. Firstly, there were apparent discrepancies between the dates of the receipts and the dates of the relevant payments. The receipts were always dated the first two days of the month in accordance with the tenancy agreements, even though the payments were made in the following month. The Taxpayer suggested that the rental receipts might have been written out by Company D in advance. Secondly, the rent received was always stated as $39,000, even though there were months when a smaller amount or a higher amount was paid – for example, only $25,000 was paid from October to December 2003. The Taxpayer said he only paid $25,000 instead of $39,000 per month from October to December 2003 because he was on business trip and could not make the payments (we pause to add that we have found this explanation rather strange – if the Taxpayer could not make the payments, Company D would not have been paid at all – the Taxpayer did not suggest that he paid less because he was running short of cash). When asked why the rental receipts from October to December 2003 purported to state the rent received as $39,000, when the Taxpayer had only paid $25,000, the Taxpayer said that his wife had helped him pay the remaining sum. This allegation, however, does not sit well with the records – Company D's bank account did not record any additional payments of the shortfall made by anyone (whether by the Taxpayer's wife or otherwise) in the months between October to December 2003. Thirdly, the amount in the rental receipts from April 2002 to March 2003 was stated to be 'Thirty Thousand & Nine Hundred' instead of 'Thirty Nine Thousand'. The Taxpayer explained the error as arising from the fact that his wife's English standard was low. As far as this third aspect is concerned, we accept the Taxpayer's explanation. We accept that the error was merely an innocent mistake on the part of the Taxpayer's wife, and we do not draw any adverse inference against the Taxpayer merely from such error.

44. The Taxpayer told us that he acted as a guarantor of Company D's mortgage application to assist his wife in her business.

45. As pointed out above, in the mortgage loan application by Company D, it was stated that the Property was 'owner occupied'. Further, the Taxpayer's name and income appeared in the entry 'Borrower's Income'. The form was signed by the Taxpayer's Wife and her sister (another director of Company D). The Taxpayer told us that this page was filled in by his Wife. The Taxpayer, however, did not dispute the correctness of the form.

46. The rateable value of the Property was decreasing from 1998 to 2004. However, the rent throughout the entire period had remained at $39,000 per month. Records from Company J showed that from 2001 to 2002, the market rental of apartments comparable to the Property were around $30,000 per month. None of the comparables was able to command a monthly rental at more than $39,000 per month. The Taxpayer told us that the higher than market rent was justified because the Property was fully furnished and renovated. However, most of the renovations appeared to have been done in late 1992, and

in any case before 1997. The Taxpayer agreed that there was no renovation between 1998 and 2004. The Taxpayer considered that while the rent paid might tend to be on the high side, it was not excessive compared with market rentals. When confronted with the rental of an apartment nearby (at $28,000 in December 2001), the Taxpayer ventured to guess that the unit was probably not renovated.

Discussion

Is there a genuine landlord and tenant relationship?

47. Quite apart from the fact that by law, the 1997 Agreement, the 1999 Agreement and the 2001 Agreement are not admissible as evidence, the failure to stamp the tenancy agreements in itself manifests an intention not to treat them as binding legal agreements to be carried out according to its terms.

48. In this regard, we gratefully adopt the view expressed by the Board in its decision D78/03, IRBRD, vol 18, 801. The taxpayer there was one of the directors and a majority shareholder of a Company A. He was given substantial sums by Company A for the purported rents he paid to Company B. Company B was a company owned by the taxpayer and his wife. In holding that there was no genuine relationship between him and Company B, the Board held, at paragraph 17:

> ' *Quite apart from the fact that the Agreement is inadmissible as evidence for lack of proper stamping, the Taxpayer's ignorance of the stamping requirement, in itself, reflects that the parties to the Agreement had no genuine intention to carry out the terms of the Agreement. Had they the intention to do so, they would have been mindful to read the Agreement carefully and would have realized that the Agreement needed to be stamped. The lack of intention on the part of the parties to the Agreement to carry out the terms of the Agreement is further illustrated by the fact that the Taxpayer never abided by the terms of the Agreement to pay the rent in advance on the first day of each month. The Taxpayer admitted that rents were not paid in cash nor on the dates as stated on the purported rental receipts. Thus we place no weight on the receipts produced which we find are unable to establish the claim of payment of rent or the existence of a tenancy of the Property between the Taxpayer and Company B. While we say this, we are aware of the fact that there were monthly cheques deposited by the Taxpayer into Company B's account which the Taxpayer claimed comprised the monthly rents. However, we are not prepared to accept that a part of this monthly payment by the Taxpayer represented the alleged monthly rental payment. Given the way in which the Taxpayer kept his current account with Company B and the fact that the amounts of those cheques always corresponded with the amounts of the mortgage repayments, we do not believe that parts of those monthly payments were meant to be the purported monthly rents. We are of the view that the monthly cheque deposits were the Taxpayer's loans to Company B to cover the*

> *mortgage repayments, which were to be reduced by the amounts which he would recover from Company A.*' (underline added)

49. The Board in D78/03 reached its conclusion by rejecting all evidence of tenancy agreement in that case. However, the Board also emphasized '[t]he lack of intention on the part of the parties to the Agreement to carry out the terms of the Agreement'.

50. The terms of the 1999 Agreement, the 2001 Agreement, and the 2003 Agreement are inconsistent and contradictory. For the same overlapping period of tenancy (i.e. from 1 April 2001 to 30 November 2003), the tenancy was apparently governed by inconsistent terms under the different agreements. We have already pointed out above the existence of a break clause in the 2003 Agreement but not the 2001 Agreement. Moreover, both the 1999 Agreement and the 2001 Agreement provided that the management fees, electricity and water charges were to be borne by Company D during period from 1 April 2001 to 30 November 2003. On the other hand, the 2003 Agreement provided that these expenses were to be borne by the Taxpayer during the relevant period.

51. The fact that Company D declared in its mortgage application form to Bank H that the Subject Property was 'owner-occupied' does not sit well with the case presently advanced by the Taxpayer that the same was in fact leased to him. We however remind ourselves that the application form was not in fact signed by the Taxpayer (it was signed by the Taxpayer's wife and her sister) and therefore could not be treated as a declaration by the Taxpayer himself against interest.

52. The way the payment of rentals was made by the Taxpayer further raises serious doubts as to the genuineness of the alleged landlord and tenant relationship. The tenancy agreements provided that the rentals were to be paid on the first day of each month. In actual fact, however, the rentals were paid in arrears. The Commissioner's representative submitted that this showed that the parties did not intend to abide by the terms of the tenancy agreements. We, however, do not place much weight on this, for there is a difference between parties having an intention to make a legally binding agreement and failing to comply with the terms as a matter of fact. If the parties ostensibly make an agreement but never intend to carry it out, the agreement may properly described as a sham and accordingly fictitious. If the parties make an agreement, intending to be bound by it, but subsequently fail to follow the terms, the agreement is not fictitious. Obviously the conduct of the parties may shed light on their intention, but mere failure to follow the strict terms of an agreement does not in itself render the agreement fictitious: one would have to look at all the circumstances and the inherent likelihood to come to a conclusion on whether it was merely a case of failure to perform or a lack of intention to carry out an agreement ostensibly made.

53. The lateness, even the consistent lateness in the payment of rental, without more, does not show that the tenancy agreements were fictitious agreements. However, there is much more to this in this case. As already noted above, the payments made by the Taxpayer purportedly as payment of rentals simply did not tally well with the monthly

rentals purportedly payable under the relevant tenancy agreements. In many months, the payments were significantly more than the rentals supposedly payable; and in some other months, they were less. For example, the Taxpayer only paid $30,000 on 3 April 2000 as rental. He sought to explain this by claiming that, out of the excess payment of $11,000 in March 2000, $9,000 was actually rent prepaid for April 2000. This seems to us to be an extremely lame and artificial explanation, and the Taxpayer was unable to explain why such pre-payment was made, and why if there was indeed such a pre-payment as alleged, in its accounts Company D did not book the amount as a rental pre-payment but as an 'Amount due to Director'. We have also pointed out that, in the months between October to December 2003, the Taxpayer had only paid $25,000 to Company D as rental, and the rather strange explanation given by the Taxpayer in that regard. The rental receipts were plainly inaccurate in reflecting the true situation of rental payments – irrespective of the amounts of payments actually made, and irrespective of the time of payments, they invariably purported to state that rentals in the sum of $39,000 were paid on the first or second day of each of the months in question. We cannot in these circumstances rely upon the rental receipts as documents correctly evidencing the rental payments.

54. We also bear in mind the close relationship between the Taxpayer and Company D. Although the Taxpayer is not a director or shareholder of Company D, he is the husband of its director and major shareholder. The Taxpayer purported to describe himself as a director of Company D when Company D made the mortgage application to Bank H. That is not to say that we regard the Taxpayer as the *alter ego* of Company D, nor are we saying that the Taxpayer is not a separate legal personality from Company D. We accept that there is no general rule that merely because a wife owns a property (either through herself or through a company), the husband is entitled to stay or use the property rent-free. There is of course no such rule. In the present case, we recognise and have carefully considered the fact that the Taxpayer could well have rented a similar property from a third party landlord, and Company D could well have rented out the Subject Property to another tenant, and the Taxpayer would still be able to claim rental refunds from the Employers. It might have served his interest better for him to have done that. But the fact is that that was not what he did. It is our duty to carefully consider what in fact had happened, and to determine whether on the evidence there was a genuine landlord and tenant relationship. The fact remains that the lettings in the present case were not made by parties dealing with each other at arms-length, and we have borne that in mind in our consideration of the evidence. It is a relevant factor but plainly not a conclusive factor. One can create a genuine tenancy relationship with a spouse (or a company controlled by a spouse). As is often said, each case depends on its own facts.

55. The pattern of payments made by the Taxpayer speaks volumes of its not being payments of rental. Not only did the amount of the payments fail to tally with the amount of the supposed rental, the records show that the cheque payments made by the Taxpayer were usually made just a few days before the mortgage loan instalments were due. The amounts of the cheque payments were more or less geared to the amounts of the mortgage loans instalments. Save for the year of assessment 1998/99 (in which the total amount of cheque payments was slightly lower than the total amount of mortgage loan payments), in other

years the total sum paid by the Taxpayer was more than the total amount of the mortgage loan instalments. After the Bank H mortgage was redeemed on 6 September 2003, the amounts of the payments made by the Taxpayer to Company D fell significantly to about $25,000 per month, although there was supposedly no change in the amount of the monthly rental payable. Such a pattern of payment seems to us to point inexorably to the fact that the payments made by the Taxpayer were not for the purpose of paying rent but to assist Company D in paying off its mortgage, and possibly also for the purpose of assisting the Taxpayer's wife in her business.

56. As rightly pointed out by the Commissioner's representative, Company D's accounts show that the excess payments made by the Taxpayer were booked in its account 'Amount Due to Director' even though he was never a director of Company D. Subsequently, Company D claimed (in a letter dated 16 August 2006 sent by Company D to the Assessor) that the excess payments were in fact loans made to Company D on behalf of its director. In his Notice of Appeal, however, the Representative contended on behalf of the Taxpayer that the excess payments were repayments of loan by the Taxpayer to his wife. There is however no evidence of what amount of loans, if any, were made by the Taxpayer's wife to which the alleged repayments relate. The fact that different versions of explanations were offered by the Taxpayer at different times certainly do not help in advancing the credibility of any one of these different versions.

57. We hold, on the totality of the evidence before us, that the Taxpayer has failed to discharge his burden (provided under section 68(4) of the Ordinance) in proving to us that there existed a genuine tenancy relationship between him and Company D such as to render the additional salaries assessments (made on the basis that there was no such relationship) excessive or incorrect.

Artificial or fictitious transaction

58. We would go even further. On the evidence we would not only hold that the Taxpayer has failed to discharge his burden under section 68(4), we hold that the evidence does show that the purported lettings of the Subject Property by Company D to the Taxpayer, and the purported payments of rental by the Taxpayer to Company D were artificial or fictitious transactions within the meaning of section 61 of the Ordinance.

59. Insofar as the transactions were fictitious, we would refer to the matters mentioned above (in paragraphs 48 to 58 above) on the lack of a genuine tenancy relationship, which we will not repeat.

60. On artificiality, which is an expression of wider import than 'fictitious', we would refer to the lack of arms-length and the closeness between the Taxpayer and Company D.

61. The fact that the purported rental of the Property was kept constant throughout the years between 1998 and 2004, when the rateable values of the Subject Property had been

falling continuously, fortifies our view that the transactions were artificial.

62. The fact that the Taxpayer had been paying Company D much more than he was obliged to pay under the relevant tenancy agreements speaks of the artificiality of the Impugned Transactions.

63. We accordingly hold that the Commissioner was entitled, pursuant to section 61 of the Ordinance, to disregard the purported tenancy agreements in assessing the rental refunds made by the Employers to the Taxpayer as income fully assessable to salaries tax.

Section 61A of the Ordinance

64. As we have concluded that the Taxpayer has failed to discharge its burden of proving that there existed a genuine tenancy relationship (with the result that he has failed to prove that the additional salaries assessments were excessive or incorrect), and that section 61 of the Ordinance applies to entitle the Commissioner to disregard the purported tenancy agreements, there is no need for us to make any further findings or decision in respect of section 61A of the Ordinance. We would accordingly mention our conclusion under that section only very briefly.

65. We would indicate, however, for the sake of completeness, that if we were called upon to make a decision under section 61A of the Ordinance, we would have held that the section also applies to the present case, and that the sole or dominant purpose of the making of the purported tenancy agreements and the purported payments of rentals thereunder was to enable the Taxpayer to obtain a tax benefit.

66. The fact that the Impugned Transactions would have, but for the effect of section 61A, enabled the Taxpayer to obtain a tax benefit (in the form of a reduction of his salaries tax liability) is amply demonstrated by the tax computation submitted to us.

67. On the objective facts, and having regard to the 7 matters set out in section 61A(1), we take the view that a reasonable person would objectively conclude that the Impugned Transactions were entered into and carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit:

(a) the Taxpayer was the guarantor of the mortgage loan of Company D and had admittedly made payments to Company D to enable it to meet its mortgage obligations. The Taxpayer would be liable to Bank H if Company D were to fail in its repayment obligations. The tenancy agreements were made, in our view, to serve as a façade in disguising the payments that the Taxpayer would have to make in support of Company D's financial position as rental payments;

(b) the tax computation made by the Commissioner shows that if the Impugned Transactions were not counteracted or disregarded, the Taxpayer would have been able to save $334,637 by way of salaries tax during the relevant years of assessment;

(c) the financial position of the Taxpayer would have been improved to the extent of the tax savings that he would be able to make from the Impugned Transactions;

(d) as a result of the Impugned Transactions, Company D would be able to receive funds from the Taxpayer to finance the mortgage loan instalments and other expenses at no costs; and

(e) the Impugned Transactions would have created rights and obligations which would not normally be created between persons dealing with each other at arm's length (e.g. in maintaining the rental at $39,000 despite the continuous fall in rateable value, and at a level higher than the market rental of comparable properties).

68. We would accordingly have held (if it was necessary for us to decide the question) that the Commissioner is entitled to disregard the Impugned Transactions and/or to counteract the same pursuant to section 61A(2) of the Ordinance.

Conclusion

69. For the reasons above, we would dismiss the appeal of the Taxpayer.