

**Case No. D8/14**

**Salaries tax** – company directorship – sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance – distinction between an office and an employment in salaries tax – whether or not the sum is from an office – whether or not the sum arose in or derived from Hong Kong.

Panel: Chow Wai Shun (chairman), Mohan Datwani and Lam Ting Kwok Paul SC.

Date of hearing: 17 April 2014.

Date of decision: 10 June 2014.

Company A and Company B were both companies incorporated in Hong Kong. The Appellant was the chairman of Company A and the sole director of Company B. Company C is a wholly-owned subsidiary of Company A which was incorporated in Country D. Mr E was a managing director of Company C.

Company B paid sales commission to the Appellant (hereinafter referred to as ‘the Sum’) and Mr E, for they provided Company B as a platform between Company F and Company G to negotiate their transactions. The Assessor raised on the Appellant the additional salaries tax assessment for the Sum paid by Company B. The Assessor did not accept the Appellant’s claim that the Sum was not chargeable to salaries tax.

The Appellant’s grounds of appeal contended that: (1) the Sum was not derived from the office of the Appellant’s directorship in Company B, but from the work initiated by Mr E in Country D; and (2) the Appellant allowed Company B to act as the intermediary between Company F and Company G was irrelevant in determining the location of the employment. In considering the location of employment, it should be noted that the sales and the commissions thereon, which were booked in the accounts of Company B, were originated in Country D by Mr E.

The issue is whether the Sum is subject to salaries tax.

**Held:**

1. A company directorship is well known and accepted as an office. As provided under section 9(1)(a) of the Inland Revenue Ordinance, income from an office include any commission, as the sum is both called and in substance (Great Western Railway v Bater [1920] 3 KB 266 followed).

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2. For salaries tax purposes, the most important distinction between an office and an employment is that the rules of determining whether income from an office arises in Hong Kong differ from those relating to employment. In this regard, it has been long established that the office of a director is located in the place where the company is located. Consequentially, where a company is managed and controlled in Hong Kong, whether or not incorporated as a Hong Kong company, income paid to a director is treated as having a Hong Kong source for salaries tax purposes. Neither the extension of the basic salaries tax charge under section 8(1A) of the Ordinance, nor the exclusion under section 8(1A)(b) or (c), has any application to such income (D15/71, IRBRD, vol 1, 72; McMillan v Guest [1942] AC 561; Goodwin v Brewster (1951) 32 TC 80; De Beers Consolidation Mines v Howe (1906) 5 TC 198 and Wood v Holden [2006] 1 WLR 1393 followed).
3. In such capacity, the Appellant allowed or caused the relevant transactions to be carried out as sales and purchases of Company B. He approved Company B's financial statements and accounts in which the Sum was declared as remuneration to director and that was paid to him. It is clear to us that but for holding the office of directorship with Company B, the Appellant would not have been in any position to be paid or to receive the sale commission. The Sum is income from an office.
4. Company B is a company incorporated in Hong Kong, maintaining a business address here, carrying on business here and at all relevant times having board meetings held in Hong Kong. It is clear to us that Company B was a company resident in Hong Kong. Consequentially, the Appellant's office as director of Company B was located in Hong Kong. On such basis, the Board conclude that the Sum, being the relevant office income, arose in or was derived from Hong Kong. It is subject to salaries tax as provided under section 8(1) of the IRO.

**Appeal dismissed.**

Cases referred to:

Great Western Railway v Bater [1920] 3 KB 266  
D15/71, IRBRD, vol 1, 72  
McMillan v Guest [1942] AC 561  
Goodwin v Brewster (1951) 32 TC 80  
De Beers Consolidated Mines v Howe (1906) 5 TC 198  
Wood v Holden [2006] 1 WLR 1393

Financial Controller of the Appellant's Company for the Appellant.  
Ng Ching Man and Chow Cheong Po for the Commissioner of Inland Revenue.

**Decision:**

1. The Appellant appeals against a Determination of the Deputy Commissioner of Inland Revenue dated 5 December 2013 in respect of the Additional Salaries Tax assessment for the year of assessment 2008/09 raised on him ('the Determination').

2. The Appellant did not attend the hearing. He was represented by the Financial Controller of Company A. No witness was called and no further documentary evidence has been adduced by or for and on behalf of the Appellant.

3. In such circumstances, we find the facts upon which the Determination was arrived at as relevant facts of this appeal:

(1) Company B is a private company incorporated in Hong Kong in 1994. During the year ended 31 March 2009, Company B had 1,000 ordinary shares in issue. The Appellant held 999 shares in Company B (i.e. 99.9%) and was the sole director of Company B. The principal activity of Company B during the year was trading in eyewear products.

(2) Company A is a private company incorporated in Hong Kong in 1997. During the year ended 31 March 2009, Company A had 2,000 ordinary shares in issue. The Appellant's shareholding in Company A changed from 1,908 shares (i.e. 95.4%) to 1,898 shares (i.e. 94.9%) on 19 June 2008. The Appellant was the sole director of Company A. The principal activities of Company A during the year were investment holding and provision of management and other services to its subsidiaries.

(3) At all relevant times, Company B and Company A maintained the same business address in Hong Kong.

(4) Company C is a wholly-owned subsidiary of Company A which was incorporated in Country D in 2001. At all relevant times, Company C was engaged in the trading of eyewear products. Mr E was a managing director of Company C.

(5) In May 2009, Company A submitted an Employer's Return of Remuneration and Pensions for the year ended 31 March 2009 ('Employer's Return') in respect of the Appellant reporting, among other things, the following particulars:

(a) Period of employment: 01-04-2008 – 31-03-2009

(b) Capacity in which employed: Director

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(c) Particulars of income:  
Salary \$1,400,400

(d) Particulars of place of residence provided by employer:  
Nature: Flat  
Period provided: 01-04-2008 – 31-03-2009  
Rent paid to landlord by employer: \$507,620

(6) In his Tax Return – Individuals for the year of assessment 2008/09, the Appellant declared the same particulars of salaries income and place of residence provided by employer as per paragraph 3(5) above.

(7) Based on the income return, the Assessor raised on the Appellant the following Salaries Tax Assessment for the year of assessment 2008/09:

|   |                  |
|---|------------------|
|   | \$               |
| Income  | 1,400,400        |
| Value of residence provided (10% x \$1,400,400) | <u>140,040</u>   |
|   | 1,540,440        |
| <u>Less: Deductions</u>                         | <u>12,000</u>    |
|   | 1,528,440        |
| <u>Less: Allowances</u>                         | <u>316,000</u>   |
| Net Chargeable Income                           | <u>1,212,440</u> |
| <br>  |                  |
| Tax Payable thereon (after tax reduction)       | <u>186,114</u>   |

The Appellant did not object to the above assessment.

(8) On 12 August 2009, the Appellant approved Company B's financial statements for the year ended 31 December 2008 which recorded, among other things, turnover of US\$1,194,340 against which sales commissions of US\$59,717 (i.e. 5% on turnover) were expensed.

(9) In a supporting schedule to the tax computation submitted with its Profits Tax Return for the year of assessment 2008/09, Company B disclosed that the above sales commissions were paid to the Appellant and Mr E in the respective amounts of US\$47,774 ('the Sum') and US\$11,943 for introducing customers to it for the year ended 31 December 2008.

(10) The Sum paid to the Appellant for the year ended 31 December 2008 were disclosed in Company B's financial statements as director's remuneration (under the category of other emoluments) pursuant to section 161 of the Companies Ordinance ('the CO').

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(11) On 2 December 2009, the Inland Revenue Department issued Employer's Returns to Company B for completion. Company B then submitted an Employer's Return in respect of the Appellant reporting, among other things, the following particulars:

(a) Period of employment: 01-04-2008 – 31-03-2009

(b) Capacity in which employed: Chairman

(c) Particulars of income:  
Commission [The Sum]

(d) Particulars of place of residence  
provided: Not provided

(12) The Employer's Return in paragraph 3(11) above was submitted under a covering letter from Company B's tax representative, Company A, which outlined the background of the reported commission as follows:

(a) During the year ended 31 March 2009, Company B accrued sales commissions on sales made to Company F at the rate of 5%. The commissions were allocated to the Appellant and Mr E. The Appellant was the Chairman of Company B and Company A. Company A wholly owned Company C the managing director of which was Mr E.

(b) Company F was a major customer of Company C. During 2008 Company F had some products made by a Hong Kong company named Company G for sale in Country D. However, under certain agreements Company F could not purchase directly from Company G. Mr E initiated negotiations between Company F and Company G. Whilst Company F would negotiate direct with Company G on its purchases, Company G would sell the goods to Company B and Company B would onward sell those goods to Company F. All the goods were sent from Company G direct to Company F and at no time did Company B maintain any stock in Hong Kong. 5% of sales were set aside as sales commissions for Mr E's effort in those transactions and he allocated the Sum to the Appellant.

(c) As the sales commissions were passive income arose from Mr E's work performed in Country D and were therefore not subject to Salaries Tax, they were not reported when Employer's Returns were submitted in May 2009.

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- (13) The Assessor raised on the Appellant the following Additional Salaries Tax Assessment for the year of assessment 2008/09 to assess the commission income reported by Company B:

|   |                |
|---|----------------|
|   | \$             |
| Additional Net Chargeable Income ([The Sum] x 7.7428) | <u>369,904</u> |
| Additional Tax Payable thereon                        | <u>62,884</u>  |

- (14) Company A, on behalf of the Appellant, objected to the above additional assessment. With a similar account as in paragraph 3 (12) above, it was contended that the Sum earned by the Appellant, being arose entirely from Mr E's work performed in Country D, did not have a Hong Kong source and were therefore not subject to Salaries Tax.

- (15) In reply to the Assessor's enquiries, Company A, on behalf of the Appellant, stated the following:

- (a) Mr E's work on the sales from Company G to Company F was minimal. All negotiations and conclusions of the sales transactions were conducted directly between Company F and Company G. Company B incurred sales commissions just to recognise Mr E's extra duty to facilitate the direct negotiation between Company F and Company G on top of his position as the managing director of Company C.
- (b) The commission income was passive in nature and there was no actual work done by the Appellant to earn the commissions.
- (c) The Appellant was entitled to a higher portion of the purely passive commission income than Mr E because the Appellant was the founder of Company C and had established the business relationship with Company F and Company G. Company F and Company G were respectively a major customer and supplier of Company C.
- (d) The Appellant was paid the Sum by Company B on 18 June 2010.
- (e) The Appellant did not have an employment contract with Company B.

- (16) In reply to the Assessor's enquiries, Company A, on behalf of Company B, stated the following:

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- (a) Company B had no relationship with either Company F or Company G. The Appellant founded Company C and built up a good business relationship with Company F and Company G.
- (b) There was no contract between Company B and the Appellant or Mr E. It was verbally agreed between the Appellant and Mr E, prior to the agreement that Company B would act as an intermediary for Company F and Company G, that they would be paid sales commissions.
- (c) The verbal agreement for paying sales commissions was discussed between the Appellant and Mr E. As Company B was to earn an unexpected passive income in 2008, the Appellant and Mr E decided to pay themselves a commission from Company B.
- (d) The commission income was passive in nature. The Appellant and Mr E did not perform any work to earn the sales commissions. They only provided a platform, i.e. making Company B as an intermediary between Company F and Company G to negotiate their transactions.
- (e) The Appellant did not decide or approve Company B acting as an intermediary between Company F and Company G, making purchases from Company G and making sales to Company F. All negotiations of purchases / sales and delivery of goods were conducted directly between Company F and Company G. Company B earned a passive spread of 20% on each transaction and it did not pay Company G before receiving payment from Company F. Therefore Company B had no exposure in the transactions and was not involved in 'authorising' the transactions.
- (f) Although the Appellant did not provide any service to Company B, the business relationship he built up with Company F and Company G facilitated the business transactions between the two companies through Company B. Therefore Company B paid the Appellant the Sum.
- (g) The Appellant, being the Chairman, was the only employee of Company B as at 31 March 2009.
- (h) As Company B had no business activities other than booking the passive transactions with Company F and Company G, the only duties of the Appellant were to satisfy those of a director as required under the CO.

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- (i) All board meetings of Company B during the year ended 31 March 2009 were held in Hong Kong.
- (17) The Assessor did not accept the Appellant's claim that the Sum was not chargeable to Salaries Tax. Besides, the Assessor considered that Company A and Company B were associated corporations and that the Appellant's income from Company B should be included in the computation of value of residence provided under section 9(2) of the Inland Revenue Ordinance ('the IRO'). The Assessor proposed to the Appellant to revise the Additional Salaries Tax Assessment for the year of assessment 2008/09 as follows:

|   |                |
|---|----------------|
|   | \$             |
| Additional Net Chargeable Income previously assessed      | 369,904        |
| <u>Add: Value of residence provided (10% x \$369,904)</u> | <u>36,990</u>  |
| Additional Net Chargeable Income                          | <u>406,894</u> |
| <br>  |                |
| Additional Tax Payable thereon                            | <u>69,172</u>  |

- (18) In pursuance of the Appellant's objection, Company A responded as follows:
- (a) The Sum did not arise in or derive from Hong Kong as the Appellant did not do any work to earn the income.
- (b) The Sum was in respect of sales generated in Company B and had nothing to do with Company A's business. It was wrong to apply section 9(2) of the IRO on the sales commissions along with the Appellant's salary from Company A. As the Sum was not subject to Salaries Tax, it was irrelevant to the application of section 9(2) of the IRO.
- (19) The Assessor has ascertained that the Articles of Association adopted by Company B in 2004 contain, among other things, the following provisions:

(a) Clause 1

The following regulations contained in Table A in the First Schedule to the CO shall apply to Company B:

- (i) The business and affairs of the company shall be managed by the directors, who may exercise all the powers of the company (Regulation 82).

- (ii) A director may hold any other office or place of profit under the company in conjunction with his office of director for such period and on such terms (as to remuneration and otherwise) as the directors may determine [Regulation 86(3)].
- (iii) Any director may act by himself in a professional capacity for the company, and he shall be entitled to remuneration for professional services as if he were not a director [Regulation 86(5)].

(b) Clause 15(3)

Directors of Company B shall have the power to fix the salaries or emoluments of managers, agents, secretaries, clerks, shroffs, servants and workmen appointed for carrying on the business of Company B and to sanction payment of the same out of the funds of Company B.

**Grounds of appeal and the Financial Controller's submissions**

4. The Financial Controller sets out the Appellant's grounds of appeal in the notice of appeal. In particular, it is contended that the Deputy Commissioner erred in the Determination in that:

- (1) The Sum was not derived from the office of the Appellant's directorship in Company B, but from the work initiated by Mr E in Country D; and
- (2) The Appellant allowed Company B to act as the intermediary between Company F and Company G was irrelevant in determining the location of the employment. In considering the location of employment, it should be noted that the sales and the commissions thereon, which were booked in the accounts of Company B, were originated in Country D by Mr E.

5. His oral submission at the hearing did not differ much from the stated grounds of appeal.

**Our analysis**

6. The issue for us is whether the Sum is subject to salaries tax.

7. Section 8 of the IRO provides:

- '(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*

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*income arising in or derived from Hong Kong from the following sources –*

*(a) any office or employment of profit...'*

8. Section 9 of the IRO provides:

*'(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...'*

9. The standard definition of an office was given by Rowlatt J in Great Western Railway v Bater [1920] 3 KB 266 at 274:

*'... a subsisting, permanent, substantive position which has an existence independent of the person who fills it, and which is filled in succession by successive holders.'*

A company directorship is well known and accepted as an office.

10. As provided under section 9(1)(a) of the IRO, income from an office include any commission, as the Sum is both called and in substance.

11. For salaries tax purposes, the most important distinction between an office and an employment is that the rules of determining whether income from an office arises in Hong Kong differ from those relating to employment. In this regard, it has been long established that the office of a director is located in the place where the company is located: D15/71, IRBRD, vol 1, 72 at 74-76 following McMillan v Guest [1942] AC 561 and Goodwin v Brewster (1951) 32 TC 80. Consequentially, where a company is managed and controlled in Hong Kong, whether or not incorporated as a Hong Kong company, income paid to a director is treated as having a Hong Kong source for salaries tax purposes: De Beers Consolidated Mines v Howe (1906) 5 TC 198 and Wood v Holden [2006] 1 WLR 1393. Neither the extension of the basic salaries tax charge under section 8(1A) of the Ordinance, nor the exclusion under section 8(1A)(b) or (c), has any application to such income.

12. The Appellant was the sole director of Company B. According to Clause 82 of Part I of Table A in the First Schedule of the CO, which Company B specifically includes in its Articles of Association, its business and affairs shall be managed by the director who may exercise all the powers of Company B. Company B also confirmed that the duties of the Appellant were to satisfy those of a director as required under the CO.

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13. In such capacity, the Appellant allowed or caused the relevant transactions to be carried out as sales and purchases of Company B. He approved Company B's financial statements and accounts in which the Sum was declared as remuneration to director and that was paid to him. It is clear to us that but for holding the office of directorship with Company B, the Appellant would not have been in any position to be paid or to receive the Sum. The Sum is income from an office.

14. Company B is a company incorporated in Hong Kong, maintaining a business address here, carrying on business here and at all relevant times having board meetings held in Hong Kong. Again, it is clear to us that Company B was a company resident in Hong Kong at the relevant time. Consequentially, the Appellant's office as director of Company B was located in Hong Kong. On such basis, we conclude that the Sum, being the relevant office income, arose in or was derived from Hong Kong. It is subject to salaries tax as provided under section 8(1) of the IRO.

15. Section 9 of the IRO also includes, as income from any office, the rental value of any place of residence provided rent-free by the employer or an associated corporation: section 9(1)(b). This is regarded so if the employer or the associated corporation has paid all the rent for the residence: section 9(1A)(b). For the purposes of this section 9, an employee includes an office holder: section 9(6). As such, the Appellant was also an 'employee' of Company B at the relevant time. Moreover, Company B and Company A are under the control of the same person, that is, the Appellant. They are associated corporations: section 9(6). Given that Company A, an associated corporation of Company B, provided place of residence to the Appellant by way of having paid all the rent for it during the relevant year of assessment, the notional rental value prescribed under section 9(2) must be included as the Appellant's income. According to section 9(2) of the IRO, it is deemed to be 10% of the Appellant's income from Company B subject to certain deductions which are absent in this case.

16. For the reasons and analysis set out above, we dismiss the Appellant's appeal and confirm the additional assessment as set out in paragraph 3(17) above. We do not find it necessary to deal with the alternative submission on whether the Sum is income from an employment located in Hong Kong. Even if we had to, we would accept the Respondent's submissions and hold against the Appellant.