

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D103/97

**Salaries tax** – tax scheme – whether the monies paid to the company wholly owned by the taxpayer and his wife could properly be regarded as remuneration to the taxpayer – whether the settlement payment by the employer was referable to the taxpayer’s employment.

Panel: Geoffrey Ma Tao Li SC (chairman), Lim Ken Y and William Tsui Hing Chuen.

Date of hearing: 27 October 1997.

Date of decision: 9 February 1998.

The taxpayer entered into an employment agreement with Z Ltd. He then became a shareholder of Y Ltd which was wholly owned by himself and his wife. After becoming a shareholder, the taxpayer wrote to Z Ltd ‘instructing’ them to divide the remuneration between him and Y Ltd. However, after taking tax advice, the taxpayer wrote to Z Ltd between him and Y Ltd. However, after taking tax advice, the taxpayer wrote to Z Ltd again confirming cancellation of his agreement with Z Ltd and withdrawing his letter of ‘instruction’.

Z Ltd and Y Ltd then entered into an agreement of service and on the same day Z Ltd confirmed to the taxpayer his employment with Z Ltd at a monthly salary of \$10,000 and that all other offers were superseded.

Y Ltd had a number of service agreements with other clients apart from Z Ltd and did issue invoices at various times to various clients.

The taxpayer, ‘as an employee’ of Z Ltd made a claim for various sums against Z Ltd in the Labour Tribunal. The case was settled and a term of the settlement stated that ‘Z Ltd do pay the taxpayer [\$204,000, being] 45 days of salary at the monthly salary of \$136,000’. The taxpayer declined the suggestion of the presiding officer of the Labour Tribunal that the said sum of \$204,000 could be paid directly into Court by Z Ltd. Z Ltd subsequently informed the IRD that the said payment was ‘leave pay fee’.

Held:

(1) The changes which took place after the taxpayer had taken tax advice was a tax scheme making the taxpayer’s position more tax efficient. The substance of the relationship between the taxpayer and Z Ltd was as reflected in the original employment agreement. Y Ltd was no more than a convenient receptacle for the emoluments that the taxpayer received from Z Ltd. The way that both the taxpayer

## INLAND REVENUE BOARD OF REVIEW DECISIONS

and Z Ltd treated the question of terms of the taxpayer's employment when the dispute arose leading to the Labour Tribunal case was decisive.

(2) Quite clearly, the settlement figure of \$204,000 was referable to monies due to the taxpayer from his employment with Z Ltd. The taxpayer should not be allowed to go behind the represented facts contained in the documents. There was no difference whether payment was direct or through the Court.

### **Appeal dismissed.**

Jennifer Chan for the Commissioner of Inland Revenue.  
Taxpayer in absentia.

### **Decision:**

#### **The issues**

1. Mr X, the Taxpayer, appeals in these proceedings against a written determination by the Commissioner of Inland Revenue dated 31 August 1996. The determination increased the Taxpayers' salaries tax liability for the years of assessment 1990/91 to 1992/93 as well as made an original assessment of the Taxpayer's salaries tax liability for the year of assessment 1993/94.

2. The Taxpayer was late in giving his notice of appeal against the determination. However, no point was taken by the Commissioner on the late appeal and we therefore extended time under section 66 of the Inland Revenue Ordinance ('the IRO') and proceeded with the appeal.

3. At the hearing of the appeal, the Taxpayer did not appear. He had already earlier by a letter dated 30 April 1997 applied to have his appeal heard in his absence under section 68(2D) of the IRO. We did so. However, we had the benefit of a clear Statement and Submission of Evidence from the Taxpayer, for which we are grateful. We are also grateful to Mrs Jennifer Chan (for the Commissioner) for her clear submissions.

4. The basic facts asserted by the Taxpayer are as follows (our additions to these are in brackets):

- (a) Prior to becoming a shareholder of a company called Y Limited, the Taxpayer entered into an employment agreement with Z Limited contained in a Letter of Appointment dated 24 January 1990. (This agreement contained a number of clauses dealing with matters often expected to be seen in such agreements (salary, bonus, housing allowance, travelling allowances etc.). The Taxpayer's salary was stated to be \$92,000 a month with year end and profit bonuses as well as a housing allowance of \$40,000.)

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) After becoming a shareholder of Y Limited (by a letter dated 21 February 1990) the Taxpayer wrote to Z Limited 'instructing' them to divide the remuneration between him and Y Limited. (In that letter, Z Limited were requested to split the Taxpayer's salary and housing allowance between Y Limited and the Taxpayer personally. Specifically, Z Limited were to pay \$122,000 a month to Y Limited and \$10,000 to the Taxpayer's personal account).
- (c) After taking tax advice, by a letter dated 2 March 1990, the Taxpayer wrote to Z Limited confirming cancellation of the said Letter of Appointment dated 24 January 1990 and withdrawing the said letter dated 21 February 1990.
- (d) Z Limited and Y Limited then entered into an agreement for services for aerospace consultancy dated 14 March 1990. By a letter dated 21 March 1990, Z Limited confirmed that it would pay Y Limited 'an aircraft technical consultation fee' of \$122,000 a month.
- (e) By a letter also dated 21 March 1990, Z Limited confirmed to the Taxpayer that he would be employed as vice president technical at the monthly salary of \$10,000 and that all other offers were superseded.
- (f) Y Limited had a number of service agreements and confirmation letters from clients other than Z Limited.
- (g) The Taxpayer had a service agreement with Y Limited dated 1 April 1990 and was employed as a consultant at the monthly salary of \$5,000.
- (h) Y Limited did issue invoices at various times to various clients.
- (i) The Taxpayer, 'as an employee' of Z Limited made a claim for various sums against Z Limited in the Labour Tribunal. (This case arose from the termination of the Taxpayer's employment with Z Limited. The Particulars of Claim filed by the Taxpayer were for leave pay, travelling allowance and payment of profit bonus. The claim for leave pay amounted to \$330,000. This was substantially in excess of a salary of \$10,000 a month.)
- (j) That case was settled with Z Limited paying the Taxpayer the sum of \$204,000 on or about 20 April 1994. (A written terms of settlement dated 20 April 1994 was signed by the Taxpayer and Z Limited. Clause 2 stated, 'THAT [Z Limited] do pay [the Taxpayer] 45 days salary at the monthly salary of \$136,000, in the sum of \$204,000 as agreed within 7 days or soonest possible.'
- (k) (By a letter dated 13 September 1994), Z Limited informed the IRD that they had paid the Taxpayer \$204,000 being 'leave pay fee'.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (l) At the hearing of the case in the Labour Tribunal, the presiding officer pointed out that the said sum of \$204,000 could be paid directly into Court by Z Limited but this was declined by the Taxpayer.
5. The appeal raises 2 issues:
- (a) Were the monies paid to Y Limited by Z Limited over the relevant period properly regarded as remuneration to the Taxpayer from Z Limited and therefore liable to taxation? **(Issue One)**
  - (b) Is the payment of \$204,000 to be regarded as part of the Taxpayer's assessable income and therefore liable to tax. **(Issue Two)**

### **Determination**

#### **Issue One**

6. The Taxpayer's case is simple. There was a genuine consultancy agreement between Z Limited and Y Limited for which consultancy fees were payable. Y Limited genuinely carried out the business of providing consultancy services and this was evidenced by the fact that Z Limited were not its only customer. The relationship between the Taxpayer and Z Limited was indeed one of employer and employee but the salary was only \$10,000 a month. All the above were supported by documents. In the circumstances, the payments made by Z Limited to Y Limited were not taxable as part of the Taxpayer's assessable income.

7. The Commissioner's case is equally simple. The consultancy arrangements and transactions between Z Limited and Y Limited (which, if genuine, would have the effect of reducing the amount of tax payable by the Taxpayer) were in fact artificial and fictitious. Section 61 of the IRO allowed the Commissioner to disregard these arrangements and the Taxpayer was therefore assessable on the payments received by Y Limited. He would be assessable by reason of the proviso to section 11D(a) of the IRO.

8. We agree with the Commissioner and are of the view that the arrangements and transactions between Z Limited and Y Limited were artificial and fictitious. We rely on the following:

- (a) The terms originally agreed between the Taxpayer and Z Limited were clearly contained in the said Letter of Appointment dated 24 January 1990. The terms were not remarkable. By the letter dated 21 February 1990, the Taxpayer sought to channel the majority of the monies payable to him by Z Limited into Y Limited. It is to be noted that Y Limited was a company wholly owned by the Taxpayer and his wife.
- (b) Only after the Taxpayer had sought tax advice did the documentation become somewhat unusual. The original terms of employment were rejected and the

## INLAND REVENUE BOARD OF REVIEW DECISIONS

letter dated 21 February 1990 was withdrawn (indeed the phrase used was that this letter should be 'struck from the records'). There were then generated agreements between Z Limited and Y Limited (the Agreement for Services), between the Taxpayer and Z Limited in which the Taxpayer was to be employed in the same capacity as before but for a salary of \$10,000 and between the Taxpayer and Y Limited.

- (c) Quite clearly in our view, these changes took place after the Taxpayer had sought tax advice and with a view to making the Taxpayer's position more tax efficient. Documentation was generated that maintained the Taxpayer's relationship with Z Limited but at the same time sought to reduce the Taxpayer's tax liability.
- (d) That all this was a tax scheme is evidenced by the said letter dated 2 March 1990 from the Taxpayer to Z Limited which actually refers to the fact that he had taken tax advice. In addition, as far as Z Limited were concerned, Y Limited was no more than the Taxpayer's 'shelf company': see the letter dated 10 December 1992 from Z Limited to the Taxpayer.
- (e) Despite all these changes and the new documentation generated, we find that the substance of the relationship between the Taxpayer and Z Limited was as reflected in the Letter of Appointment dated 24 January 1990. In our view, Y Limited was no more than a convenient receptacle for the emoluments that the Taxpayer received from Z Limited. Z Limited were quite happy to assist the Taxpayer in whatever tax scheme that the Taxpayer thought appropriate but in reality, they regarded the terms of employment as basically those set out in the Letter of Appointment.
- (f) What is decisive in our view is the way that both the Taxpayer and Z Limited treated the question of the terms of the Taxpayer's employment when the dispute arose leading to the Labour Tribunal case. When it came to the question of claiming money, the Taxpayer adopted a position quite contrary to the documentation generated after he had sought tax advice in 1990 (referred to above).
- (g) As stated above, the Particulars of Claim filed by the Taxpayer clearly went on the basis that his monthly salary from Z Limited was considerably in excess of \$10,000. In the Claim Form dated 26 January 1994 submitted to the Labour Department by the Taxpayer (and signed by him), the Taxpayer stated his monthly salary to be \$105,000. He also signed the said Terms of Settlement dated 20 April 1994 which stated that his salary was \$136,000 a month and that he was to be paid '45 days salary' making up the sum of \$204,000. The Taxpayer has submitted (albeit in relation to Issue Two but the same applies equally here) that his claim in the Labour Tribunal was misconceived and that the reference to a monthly salary \$126,000 was fictitious. We reject this submission. We find that the reality was as stated in these documents.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (h) From Z Limited's point of view, they obviously regarded the Taxpayer as an employee earning far in excess of \$136,000 a month. The Statement of Final Salary dated 26 January 1994 signed on behalf of Z Limited refers to the Taxpayer having a salary of \$136,000 a month. It was on this basis that Z Limited made a payment to the Taxpayer in the sum of \$156,713.30 in 14 February 1994 after a conciliation meeting arranged by the Labour Department.

9. The Taxpayer fails therefore on Issue One.

### **Issue Two**

10. We have already dealt with the relevant documents in relation to this issue. Quite clearly, the settlement figure of \$204,000 is referable to monies due to the Taxpayer from his employment with Z Limited. We have already drawn attention to the Particulars of Claim, the Claim Form dated 26 January 1994 submitted to the Labour Department by the Taxpayer and the Terms of Settlement dated 20 April 1994 signed by the Taxpayer. The Taxpayer should not be allowed to go behind the represented facts contained in these documents.

11. We should add that we also reject the argument that since the Taxpayer could have paid through the Labour Tribunal, the sum of \$204,000 can properly be regarded as non-taxable. There is no difference whether payment was direct or through the Court. The important inquiry for us is to examine just what this sum was referable to.

12. The Taxpayer therefore fails on the Second Issue as well.

### **Conclusion**

13. As announced at the conclusion of the hearing, the appeal is dismissed and the assessments as varied and contained in the Commissioner's determination are confirmed.