Case No. D106/89

Salaries tax – apportionment on 'time-in time-out' basis – employer paying salaries tax for employee – whether reimbursement of tax should be apportioned.

Panel: Henry Litton QC (chairman), Robert Kwok Chin Kung and Ambrose Lau Hon Chuen.

Dates of hearing: 11, 12, 17 and 22 January 1990.
Date of decision: 19 March 1990.

The taxpayer was employed outside of Hong Kong and it was agreed that his income should be taxed on an apportionment basis of the days he spent in Hong Kong as compared with the days he spent outside of Hong Kong. The employer reimbursed to the taxpayer under his terms of service the tax which he was required to pay in Hong Kong. The assessor assessed the full amount of the reimbursement to tax. The taxpayer claimed that the reimbursement to tax should be apportioned in the same way as his other income liable to salaries tax.

Held:

Payment by the employer on behalf of the taxpayer of his salaries tax liability was part of the taxable emoluments of the taxpayer. The time-in time-out apportionment basis for ascertaining the tax liability of the taxpayer is a rough and ready method of assessing income chargeable to tax where payment for services rendered in Hong Kong cannot be readily ascertained. When the derivation of an item of income is clearly identifiable then there is no room for the application of the time-in time-out formula. The payment of Hong Kong tax clearly refers to the services performed in Hong Kong and accordingly should not be apportioned.

Appeal dismissed.

Cases referred to:

D31/85, IRBRD, vol 2, 201
Glynn v IRC (PC) 3 HKTC 245

Wong Yui Keung for the Commissioner of Inland Revenue.
David Flux of Peat Marwick for the taxpayer.

Decision:

Introduction

1. This case concerns one item in the Taxpayer's salaries tax returns for the three years of assessment 1986/87, 1987/88 and 1988/89, namely, 'tax reimbursements'.

2. The details of the returns made by the Taxpayer are as follows:

Year Ended 31 March	1987	1988	1989
Period of employment	1-4-86 to 31-3-87	1-4-87 to 31-3-88	1-4-88 to 17-12-88
Income:			
Salary	US$24,792	US$26,016	US$31,072
COLA	4,064	4,883	4,484
FSP	4,553	5,452	4,660
Commission	-	22,800	7,729
Education	2,954	14,366	3,503
Bonus	571	-	-
Others	-	93	657
Tax reimbursements	7,059	HK$ 9,440	HK$40,904
Total income	US$43,993	US$73,610	US$52,105
		HK$ 9,440	+ HK$40,904
			+ Rental Value

3. During the three years in question the Taxpayer was employed by a US company ('X Limited') as Asia Pacific area manager, with responsibilities throughout the Asia/Pacific region including Hong Kong. His posting commenced in April 1985. He was based in Hong Kong but his responsibilities required him to travel extensively in the Asia/Pacific region and to render services to his employer outside Hong Kong. On the occasions when he was in the territory, he lived with his family. The period with which this appeal is concerned is 15 April 1985 to 17 December 1988.

4. It is common ground between the parties that the Taxpayer's 'office or employment of profit' (in terms of section 8(1)(a) of the Inland Revenue Ordinance) was not located in Hong Kong; he was only liable to Hong Kong salaries tax insofar as his income was 'derived from services rendered in Hong Kong': section 8(1A)(a).

5. The designation of the Taxpayer's employment by X Limited was area manager. He received remuneration from his employer on account of all the services he rendered in that capacity. His salary was not calculated in relation to any specific services he rendered to his employer. Accordingly, it was impossible to separate out the services rendered by the Taxpayer in Hong Kong from the total services rendered by him regionally. The situation concerning the Taxpayer is no different from that of many other 'expatriates' living in Hong Kong whose employment is in the Asia/Pacific region. In order to assess the Taxpayer's liability to salaries tax under section 8(1A)(a) of the Ordinance, the assessor employed the 'time-in time-out' basis of apportionment: on the assumption that, in relation to those days in the year when the Taxpayer was physically present in Hong Kong, he rendered services to his employer in Hong Kong. This conventional way of identifying income derived from services rendered in Hong Kong has never been in dispute. Accordingly, when the Taxpayer came to make his returns, all pecuniary benefits which he was entitled to receive from his employer (including tax reimbursements) were apportioned in accordance with this formula and offered for the purpose of the tax computation as the Taxpayer's assessable income.

6. It is the Commissioner's case that, whilst every other pecuniary benefit receivable by the Taxpayer from his employer is properly apportionable on a 'time-in time-out' basis, the tax reimbursements are not: they must be brought into the Taxpayer's salaries tax computation in full. The rationale of the Commissioner's determination is this:

> '... The tax payments or reimbursements were made pursuant to a tax equalization scheme which was a condition of the Taxpayer's posting to Hong Kong. The scheme was operated to equalize the tax burden placed on the Taxpayer so that he would not be financially disadvantaged by his posting outside the USA.
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> Clearly the payment or reimbursement of the Hong Kong salaries tax by the employer was a direct consequence of the contractual conditions of the Taxpayer's posting to Hong Kong and of the Taxpayer's liability to pay Hong Kong salaries tax in respect of income for services rendered by the Taxpayer in Hong Kong.
>
> The payments or reimbursements were not related in any way to the services rendered by the Taxpayer outside Hong Kong. Accordingly the payments or reimbursements fall to be taxed in full.'

Accordingly, the Commissioner was of the view that for the year of assessment ending 31 March 1987, the sum which should be brought into the computation as 'income derived from services rendered in Hong Kong' was US$12,354, and not the sum of US$7,059 appearing in the computation accompanying the Taxpayer's tax return.

7. The amounts in dispute are accordingly as follows:

Year ended 31 March:	1987	1988	1989
As per Taxpayer's return: tax reimbursements apportioned on time basis	US$ 7,059	HKS 9,440	HK$40,904
As per Commissioner's determination: tax reimbursements receivable in full	US$12,354	HK$13,766	HK$59,520

Contract of Employment

8. The terms of the Taxpayer's employment are found in a number of documents, but for the purposes of this case only two needed to be mentioned: a letter of undertaking dated 28 March 1985 and a policy statement. The Taxpayer's employment as area manager for the Asia/Pacific region meant that he came under the 'tax equalisation policy' of X Limited as set out in the policy statement. The principle behind the tax equalisation policy is set out in the statement in these terms:

> '[X Limited] recognizes that employees accepting overseas assignments may incur additional and varying liabilities for host country and United States income taxes, which are directly attributable to acceptance of an offshore assignment.
>
> It is the policy of [X Limited] that difference in income tax costs as a result of an offshore assignment shall not result in a significant advantage or disadvantage to an expatriate. To accomplish this objective, all employees will participate in the company's tax equalisation policy as a condition of accepting an expatriate assignment. Expatriate employees will have responsibility for liability equal to the sum of a calculated hypothetical US federal and state liability (if applicable) on their [X Limited] base income and [non-X Limited] source income as though they had remained in the US. This hypothetical tax liability represents the costs that the expatriate must pay regardless of the actual US or host country tax liability paid.
>
> The payment of personal income taxes and compliance with personal income tax requirements, both in the US and in a host country, are the responsibilities of each expatriate. This includes complying fully with all tax regulations by filing timely tax returns, making proper declarations, and providing accurate documentation as required in support of such tax returns. This is consistent with [X Limited's] policy that expatriates and the company act as responsible corporate citizens wherever [X Limited] operates worldwide.'

9. Under the letter of undertaking dated 28 March 1985 the Taxpayer's 'base salary' was US$50,000 per year payable on a monthly basis and supplemented by the payment of an expatriate allowance which consisted of three elements: expatriate premium, cost of living allowance and a US hypothetical house deduction. The Taxpayer was also entitled to be paid certain education expenses for his children.

10. The tax equalisation policy is made expressly part of the Taxpayer's conditions of employment in the letter of undertaking in these terms:

> ' The tax equalisation policy is designed to assure you of not incurring additional tax liability as a result of this assignment in excess of the tax liability you would have incurred had you remained in the United States. During the course of your assignment, a hypothetical tax will be computed and withheld from your salary, which is an approximation of your annual tax liability on your [X Limited] income had you remained in the US. If you receive any commissions, bonuses, or incentives in addition to salary, they are also subject to hypothetical tax. The final hypothetical tax will be calculated by [a firm of certified public accountants mentioned] as your tax return is finalised each year, which determines your final actual income tax obligation for the year. [X Limited] will be responsible for US and/or foreign taxes greater than the final hypothetical tax, which were incurred as a result of your expatriate assignment. The final settlement of taxes is subject to final review of any taxes paid on behalf of an expatriate or advances provided to an expatriate as part of a tax settlement.'

11. In applying the tax equalisation policy to the employees, X Limited used the firm of accountants professionally to prepare both the US and the 'host country's' tax returns. Under this procedure, the employee's monthly income from his employment had deducted from it the hypothetical tax: that is to say, the federal and state taxes the employee would have had to pay on his X Limited base income and non-X Limited source income if the employee had remained in the USA. This deduction is agreed to by the employee in signing a '[X Limited] expatriate tax equalisation policy certification' in these terms:

> ' I understand and agree that the company will reduce my monthly compensation by an amount which approximates my monthly estimated tax deduction calculated on [X Limited] base income.'

12. The result of applying this tax equalisation policy as far as the Taxpayer is concerned is that whenever a Hong Kong salaries tax assessment is made upon the Taxpayer (whether provisional or final) the demand note is satisfied directly by X Limited. As to US tax levied by the US tax authorities, this is paid in the first place by the Taxpayer, and then repaid later on by the company to the Taxpayer. As the hypothetical tax deduction is made upon the basis of suppositions with regard to taxable income which might turn out later on not to be wholly correct, a reconciliation is performed under the tax equalisation policy from

year end to year end. In the three years in question the returns made by X Limited with regard to the Taxpayer's total remuneration 'package' were as follows:

Year Ended 31 March	1987	1988	1989
Income:			
Salary	US$43,386	US$37,936	US$45,212
COLA	7,113	7,120	6,525
FSP	7,932	7,950	6,781
Commission	-	33,246	11,246
Education	5,169	20,948	5,098
Bonus	1,000	-	-
Others	-	135	956
Tax reimbursements	12,354	HK$13,766	HK$59,520
Total income	US$76,954	US$107,995 + HK$13,766	US$75,818 + HK$59,520

The 'salary' returns for 1987, 1988 and 1989 of US$43,386, US$37,936 and US$45,212 were the result of the hypothetical tax deductions and reconciliations as referred to above.

Tax Reimbursements

13. To determine the chargeability of the 'tax reimbursements' amounting to US$12,354, HK$13,766 and HK$59,520 for the three years in question, we look (i) into how the sums were made up and (ii) into the contractual position as between the Taxpayer and his employer regarding those sums.

How 'Tax Reimbursements' were Made Up

14. With regard to the figure of US$12,354 appearing in X Limited's employer's return for the year ended 31 March 1987, evidence was adduced before us to the following effect:

Assessment	Amount	Date Paid
1985/86 Provisional	HK$70,159	30 April 1986
1985/86 Final	(15,097)	overpayment credited
1986/87 Provisional (75%)	41,296	23 February 1987
	HK$96,358	
	= US$12,354	

15. As regards the subsequent two years of assessment (year ended 31-3-1988 and 31-3-1989) the evidence was as follows:

Salaries Tax charged for Year of Assessment			Amount
1985/86 (Provisional)	$70,159	)	$96,358
1985/86 (Final) & 1986/87 (Provisional) - First Instalment	$26,199	)	[@7.8 = US$12,354]
- Second Instalment			$13,766
1986/87 (Final) & 1987/88 (Provisional)			$59,520

It is therefore clear that the 'tax reimbursements' in question related wholly to the Taxpayer's liability to salaries tax in Hong Kong: liability which arose under section 8(1A)(a) on account of services rendered in Hong Kong in the first place.

Contractual Position Between X Limited and Taxpayer

16. Unquestionably, the liability to pay the sums of US$12,354, HK$13,766 and HK$59,520 was that of the Taxpayer. But, under the contractual arrangement as between employer and employee, the Inland Revenue Department demand notes were sent to the employer who then satisfied those demands by payment (see paragraph 12 above). The first question for our consideration is whether, under these circumstances, these sums come within the meaning of the words in section 8(1A): 'income arising in or derived from Hong Kong from … employment …'. Only after this question has been answered does the question of apportionment arise.

Definition of Income From Employment

17. In the course of the submissions by the parties' representatives, we were referred to D31/85, IRBRD, vol 2, 201 where, by a majority, the Board held that sums paid by an employer to an employee by way of refund of salaries tax assessed upon the employee came within section 8(1A)(a) of the Ordinance. The payment was made under a tax equalisation scheme. The Board in that case held that as the sums paid in reimbursement of salaries tax were referable solely to services rendered in Hong Kong, they were chargeable under section 8(1A)(a). Mr Flux on behalf of the Taxpayer criticizes the majority view for failing to set out in its decision the full terms of the tax equalisation scheme. The way he formulated the point for our decision in this case is this: 'Can tax equalisation payments be said to be derived wholly from services in Hong Kong? If not, it must be apportioned'.

18. Before we consider the question of apportionment, we look first of all at the foundation of liability. The payments were made by the employer X Limited direct to the Inland Revenue Department, but were in discharge of a debt of the Taxpayer. The question in our view is this: having regard to the wording of the statute we have to construe, do these payments made by the employer to the Inland Revenue Department pursuant to the contractual arrangements between employer and employee constitute 'income from employment' within the meaning of section 8(1A)(a)?

In Glynn v IRC 3 HKTC 245, the Privy Council held, after an examination of the authorities, that a perquisite included 'money expended in discharge of a debt of the taxpayer'. 'Perquisite' comes within the expanded meaning of 'income from ... employment' under section 9(1)(a).

Thus, it seems beyond argument that the 'tax reimbursements' do come within the scope of 'income from employment' under section 8(1A)(a). Indeed, this is implicitly accepted by the Taxpayer's representative who argues, not that all the 'tax reimbursements' must be excluded from the computation, but only that part of these sums should be included.

Apportionment

19. Having reached this point, what room is there for arguing that the payments made by X Limited, solely referable to the Taxpayer's liability incurred as a result of services rendered in Hong Kong, should be apportioned in accordance with the 'time-in time-out' formula? We wholly fail to see it. There is no doubt that, by treating the 'tax reimbursements' as 'income' of the Taxpayer assessable to salaries tax, there is an element of double taxation involved: the sum paid by X Limited in discharge of the Taxpayer's liability in one year becomes the foundation for tax liability in the next year. But, adopting the Taxpayer's formula, there is the same result – though to a lesser extent. This is inherent in any scheme whereby an employer agrees with an employee that as part of the 'employment package' the employer will discharge the employee's tax liability.

20. Like the majority of the Board of Review in D31/85 we are of the view that the 'tax reimbursements' are referable solely to services rendered in Hong Kong: the salaries tax liability was assessed on the Taxpayer on the basis of such services. Assume, for instance, that in the year ending 31 March 1987 the bonus of US$1,000 paid to the Taxpayer (see paragraph 12 above) was on account of services rendered wholly in Hong Kong: can there be any doubt that the US$1,000 will not be apportionable in the computation and will come into the charge in the same way as the 'tax reimbursements'? And assume the position to be the reverse, that it can be shown that the bonus of US$1,000 was paid on account of services rendered elsewhere: can there be any doubt that it should be wholly excluded?

21. In reality, the 'time-in time-out' formula of apportionment is a rough and ready method used to assess the income chargeable under section 8(1A)(a) when the derivation of

the income with reference to the services rendered cannot be identified. The application of the formula is not set in concrete, and is liable to be displaced by the facts. When the derivation of an item of income is clearly identifiable (and this can go both ways) there is no room for the application of the formula.

22. Mr Flux submitted that, viewing the contractual arrangement between X Limited and the Taxpayer, there was no specific allocation of remuneration to specific duties and therefore the whole of the remuneration including 'benefits' in the form of 'tax reimbursements' must be apportioned. He further argued that this 'tax equalisation benefit' was simply an item of remuneration computed on the basis of the extent to which all income taxes incurred by the Taxpayer (including Hong Kong and US taxes) exceeded a pre-computed ceiling (called the 'hypothetical tax') in the contract documents. If this were indeed the position, then Mr Flux could well be right: the 'time-in time-out' formula should generally speaking only be applied when an item of remuneration cannot be identified wholly with services rendered in Hong Kong. But this is not the position regarding the 'tax reimbursements'.

Conclusion

23. In our view the Commissioner was right when he said in his determination that 'the payments ... were not related in any way to services rendered by the Taxpayer outside Hong Kong'. They related solely to services rendered in Hong Kong; the salaries tax assessments on the Taxpayer were made on the basis of services rendered in Hong Kong.

24. An alternative argument was put to us by Mr Flux on the basis of a hypothetical salary of US$52,875 having been paid to the Taxpayer in the year ending 31 March 1987 rather than the actual salary of US$43,386. The supposition was that the employer paid to the Taxpayer, in effect, part of the 'tax reimbursement' amounting to US$12,354 by way of salary. Upon this hypothesis, says Mr Flux, the 'tax reimbursements' would have been much smaller. This might well have been a legitimate way whereby X Limited might have reduced its liability with regard to the Taxpayer's salary tax assessment in Hong Kong (and we make no comment in this regard), but this is not what in fact happened. We cannot deal with this appeal on the basis of suppositions. What actually took place is set out in paragraph 12 above, and on that basis the 'tax reimbursements' paid by X Limited were respectively US$12,354, HK$13,766 and HK$59,520. These sums were wholly referable to the Taxpayer's liabilities incurred in consequence of services rendered in Hong Kong. They are accordingly chargeable under section 8(1A)(a).

25. This appeal must accordingly be dismissed.