Case No. D138/01

Salaries tax – employment – source of income – section 8(1), 8(1A) and 8(1B) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Dennis Law Shiu Ming and Duffy Wong Chun Nam.

Date of hearing: 4 October 2001.
Date of decision: 18 January 2002.

By an employment agreement dated 15 January 1992, Company A agreed to employ the appellant.

Company A and Company B were companies within the same group. By letter dated 1 November 1993, the appellant was informed by Company B of the transfer of his employment to that company with effect from 1 April 1993.

By letter dated 30 November 1995, Company E confirmed the appellant's secondment to that company as from 1 December 1995. The appellant was to station full time in Company E's factory in China. The appellant's salaries and allowances 'will be autopaid to [his] designated bank account as usual by [Company B] to which [Company E] will reimburse accordingly'. Company E was a wholly foreign-owned enterprise established under the laws of the People's Republic of China.

In mid 1997, the appellant applied to Finance Company J for a mortgage loan and in his application informed Finance Company J that Company B was his employer.

The appellant ceased working with Company E on 31 August 1997 and recommenced working for Company B on 1 September 1997.

By letter dated 31 October 1997, Company L notified the appellant that his employment with Company B was deemed to have been transferred to Company L with effect from 1 November 1997.

Company B and Company L filed employer's returns in respect of the appellant for the years ended 31 March 1996, 1997 and 1998. The Revenue levied assessments on the appellant

for the years of assessment 1995/96, 1996/97 and 1997/98 on the basis of these returns by Company B and Company L. The appellant objected to the assessments.

Held:

1. The first question to be decided was whether the appellant's income arose in or was derived from Hong Kong from an employment of profit within the meaning of section 8(1) of the IRO. The Board was not satisfied with the explanations given by the appellant. The Board saw no justification as to why Company B and Company L should submit employer's returns to the Revenue and why Company L should include the appellant's years of services with Company E in computing the appellant's retirement entitlements. The Board also attached weight to the representation made by the appellant to Finance Company J. The Board therefore found that the returns by Company B and Company L for the years of assessment 1995/96, 1996/97 and 1997/98 did correctly reflect the contractual position between those companies and the appellant.

2. In relation to the years of assessment 1995/96 and 1997/98, there was no dispute that the appellant was liable for salaries tax in respect of his earnings before 1 December 1995 and after 31 August 1997. His income during those years did not come within section 8(1A)(b)(ii) of the IRO. It was common ground that for each of the years of assessment 1995/96 and 1997/98, the appellant was in Hong Kong well in excess of the 60 days' limit. The appellant therefore could not take advantage of the provisions in section 8(1B) of the IRO.

3. As far as the year of assessment 1996/97 is concerned, the Board accepted the evidence of the appellant that he rendered in China all the services in connection with his employment. The Board further accepted his evidence that his Hong Kong visits during weekdays were in return for his work during holidays in China and that his stays in Hong Kong were for purposes wholly unconnected with his employment. In these circumstances, he was entitled to the exclusion as provided by section 8(1A)(b)(ii) of the IRO.

Appeal allowed in part.

Ngan Man Kuen for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. By an employment agreement dated 15 January 1992 ('the 1992 Agreement'), Company A agreed to employ the Appellant as sales manager at a salary of $35,000 per month plus a car allowance of $2,000 per month. Under clause 9 of the 1992 Agreement, Company A reserved 'the right to second or transfer [the Appellant] to work on any project site or any yard or any factory which may be situated in Hong Kong Island, Kowloon and New Territories of the Company or its subsidiary, associate and affiliate companies, joint ventures or joint venture companies (hereinafter called "the Group") as is considered appropriate'. Under clause 14(b) of the 1992 Agreement, either Company A or the Appellant 'may terminate the employment ... by giving the other party one month written notice or payment equal to the amount of one month's salary in lieu of notice'.

2. By letter dated 1 November 1993, the Appellant was informed by Company B of the transfer of his employment to that company with effect from 1 April 1993 'due to the restructuring of the Group'. According to the Appellant, he continued to render services to Company A as sales manager/director until 30 November 1995. Company A and Company B were companies within the same group. They had their business address at Address C. In December 1996, Company A and Company B moved their offices to Centre D.

3. By letter dated 30 November 1995 sent by Company E to the Appellant ('the November 95 Letter'), Company E confirmed the Appellant's secondment to that company as 'deputy general manager' with effect as from 1 December 1995. Subject to various exceptions therein set out, the Appellant's 'terms of employment will be the same as those setting out in [his] existing employment with [Company B]'. The Appellant was to station full time in Company E's factory in District F in China. Clause 9 of the November 95 Letter provided that the Appellant's salaries and allowances 'will be autopaid to [his] designated bank account as usual by [Company B] to which [Company E] will reimburse accordingly'. Clause 11 of the November 95 Letter further provided that 'This secondment will be initially valid until 31-3-1997'. This letter was signed by Mr G as president and general manager of Company E.

4. Company E was a wholly foreign-owned enterprise established under the laws of the People's Republic of China by Company H. It manufactured magnetic media products in China. According to a business licence dated 25 December 1995, the Appellant was one of the six deputy

general managers whilst Mr G was its managing director and general manager. The Appellant was named as Company E's deputy managing director and general manager in another business licence dated 20 November 1996.

5. Company H is a private company incorporated in Hong Kong. At the material times, its business address was at the seventh floor of Centre D. Its principal activities were in the marketing of magnetic media products and related accessories. It purchased the majority of its goods from Company E. The holding company of Company H was Company I, a company listed in the Hong Kong Stock Exchange.

6. By letter dated 26 January 1996, Company B informed the Appellant that he had, up to 31 December 1995, accumulated a total of 37.5 days of annual leave. That was 23.5 days more than his annual leave entitlement. Company B paid the Appellant $40,175.34 as payment in lieu of those 23.5 days.

7. The 'secondment' of the Appellant was extended to 30 April 1998 'or any shorter period to be determined by the company' by letter dated 30 April 1996 ('the April 96 Letter') from Company E to the Appellant. The April 96 Letter provided that the Appellant be employed as acting general manager with effect as from 1 May 1996 and the terms of his employment 'will be the same as mentioned in our previous letter dated 30 November 1995 ...'.

8. In about mid 1997, the Appellant applied to Finance Company J for a mortgage loan secured by his residence at Address K. In support of his application, the Appellant informed Finance Company J that Company B was his employer and he held the position of sales director for a period of five years.

9. The Appellant ceased working with Company E on 31 August 1997. He recommenced working for Company B on 1 September 1997.

10. By letter dated 31 October 1997 from Company L to the Appellant, the Appellant was notified that 'due to the restructuring of the Group, your employment with [Company B] is deemed to have been transferred to [Company L] with effect from 1 November 1997. All employment terms remain unchanged, and your past service with [Company B] from 15-Jan-92 will be counted in full towards your level of seniority with [Company L]'.

11. Company B and Company L filed employer's returns in respect of the Appellant for the years ended 31 March 1996, 1997 and 1998 showing, inter alia, the following particulars:

Year of assessment	**1995/96**	**1996/97**	**1997/98**	**1997/98**
Name of employer	Company B	Company B	Company B	Company L
Capacity in which employed	Sales director	Sales director	Sales director	Sales director
Period of employment	1-4-1995 –	1-4-1996 –	1-4-1997 –	1-4-1997 –

	31-3-1996	31-3-1997	31-3-1998	31-3-1998
Income	$	$	$	$
- Salary	634,200	746,400	472,360	337,400
- Leave pay	40,175			
- Bonus	202,000	212,200		
- Allowance	82,333	104,777	68,513	22,500
Total	958,708	1,063,377	540,873	511,120
Whether the employee was wholly or partly paid by an overseas concern either in Hong Kong or overseas	No	No	No	No

12. The Revenue levied assessments on the Appellant for the years of assessment 1995/96, 1996/97 and 1997/98 on the basis of these returns by Company B and Company L. The Appellant objected to the assessments on the following grounds:

(a) Year of assessment 1995/96

(i) The allowance of $82,333 was overseas hardship allowance granted to him as he was required to render services in China for Company E. The allowance was calculated according to the number of days (excluding holidays and Sundays) he actually stationed and worked in mainland China. As the income was sourced in China, no profits tax was payable thereon.

(ii) During the period from 8 December 1995 to 31 March 1996, he worked exclusively for Company E. Salary of $208,000 and other fringe benefits earned by him during that period should not be assessable to tax in Hong Kong.

(iii) Alternatively, he was under a foreign employment with Company E and was entitled to exclude $459,655 from assessment computed as follows:

Assessable income for the year of assessment 1995/96 × Days to be exempted from tax / 365
= $958,708 × 175 / 365
= $459,655.

(b) Year of assessment 1996/97

His entire income should be exempt from tax under section 8(1A)(b) of the IRO as all his services were rendered outside Hong Kong.

(c) Year of assessment 1997/98

(i) His income for the period between 1 April 1997 and 31 August 1997 should be exempt from tax as he was on secondment to Company E.

(ii) He should be entitled to deduct car allowance of $31,500 from his assessable income as he incurred a total of $44,885 for that purpose.

Pre-hearing correspondence between the Revenue and various parties

13. With Company A

By letter dated 13 February 2001, Company A furnished a breakdown to the Revenue of the Appellant's earnings for the years of assessment 1995/96, 1996/97 and 1997/98. The Revenue was told that the Appellant 'was seconded to [a factory in District F in China] with effect on 23/12/95, he stationed in [District F in China] after the said date. [The Appellant] held the position of Deputy General Manager and was responsible for the overall operation of the [factory in District F in China]'. The Appellant did not tender any notice of resignation before he took up his assignment in District F in China.

14. With Company B

(a) By letter received by the Revenue on 29 January 1997, Company B informed the Revenue that overseas working allowance was granted to employee working overseas and the amount for the Appellant was calculated on a daily basis at 20% of his basic salary.

(b) By letter dated 31 May 1997, Company B informed the Revenue that the Appellant 'has been stationing in our [factory in District F] in China during the year end 31/3/97. [The Appellant] is responsible for the overall operation of the [factory in District F in China] and he has to stay in Mainland China all the time. He returned to Hong Kong during weekend for pure relaxation and personal reasons'.

(c) By letter dated 3 July 1997, Company B pointed out that:

(i) 'The master and servant relationship still exists between the Company and [the Appellant] after 1st December 1995'.

(ii) Company E 'has jurisdiction and exercises control over [the Appellant]

work during the period of secondment'.

(iii) Salary paid by Company B to the Appellant during the period of secondment was reimbursed by Company E.

(iv) The holding company of Company B holds shares in the holding company of Company E.

(d) By letter dated 27 February 1998, Company B indicated that they did not have any attendance record of the Appellant in their Hong Kong office. The Appellant was entitled to '14 days for annual leave; 10 days discrepancy plus time off in lieu of overtime worked on Saturday afternoon and Sundays'. The Appellant 'did not perform any service in Hong Kong during the period from 23 December 1995 to March 1997'. Their personnel department maintained the Appellant's annual and sick leave records but not records of his public holidays and time off. As the deputy general manager of the factory in District F in China, the Appellant 'is only required to submit his annual and sick leave records in written form. He worked out with his immediate supervisor [Mr G] to balance the leave discrepancy between working in PRC and HK'.

15. With Company L

By letter dated 5 January 2001, Company L told the Revenue that the Appellant held the position of 'Sales Director' and was responsible for all sales activities in respect of the products of Company L during the year ended 31 March 1998. The Appellant is a member of Company L's retirement scheme. He enrolled into that scheme upon transfer of his employment on 1 November 1997 and his scheme service with Company B as from 1 March 1995 was taken into account.

16. With Company E

By letter dated 21 May 1998, Company E informed the Revenue that:

(a) 'The master and servant relationship exists between this company and [the Appellant]';

(b) 'This company has jurisdiction and exercises control over [the Appellant's] work' and

(c) 'This company was responsible for the emoluments and fringe benefits of [the Appellant]'.

17. With the Appellant – The Appellant informed the Revenue that

(a) 'I was asked to attend an interview in [District F in China] in late November 1995. I was offered the Job in that interview. I negotiated and concluded the contract with [Company E's] president and legal representative at that time. I signed the contract later to indicate my acceptance of the offer to work in [Company E]. That contract is enforceable and superseded any other contracts with [Company B] during the validity period. Therefore I was (and should be treated) in the employment of [Company E] during the period of secondment'.

(b) 'I am also subject to the jurisdiction of [Company E]. I belong to the organisation of [Company E] holding the position of Deputy General Manager. Therefore a master and servant relationship exists between [Company E] and myself during the period of the validity of the contract'.

(c) In respect of the year of assessment 1995/96

(i) For the period between 1 December 1995 and 31 March 1996, he spent 12 days in Hong Kong. Those were his rest days or holidays.

(ii) For the like period, he spent an additional six days in Hong Kong on sick leave.

(d) In respect of the year of assessment 1996/97

(i) On 46 occasions, he was required to work on his rest days (Saturdays and Sundays) and public holidays. In return for such work, he was given holidays on 18 working days.

(ii) On six further occasions, he visited Hong Kong for the birthdays of his relatives, for medical appointments and during closure of the factory in District F in China.

(e) He had been paying individual income tax in China since 1 January 1997. The tax authority in China may seek retrospectively to recover from him tax in respect of the period between December 1995 and January 1997.

The hearing before us

18. The Appellant and Mr G gave sworn testimony before us.

19. According to the Appellant:

(a) He is a native of District F in China. Mr G of Company E engaged him to work for Company E due to his knowledge of the local conditions. Company A did not send him to work in Company E. The November 95 Letter was a completely new contract.

(b) Company E and Company A were not members of the same group. Whilst the holding company of Company A held some shares in the holding company of Company E, their relationship was a tenacious one.

(c) The principal business of Company E was in the production of magnetic discs. Prior to his engagement, Company E was experiencing two major problems. First, there was substantial loss in raw materials due to pilfering within its factory. Secondly, there were disputes with the power supply company as to the quantity of electricity consumed. His local knowledge was crucial in resolving these issues.

(d) Initially the factory in District F in China employed about 7,000 workers. This was reduced to about 900 when he left. He did not have regular working hours whilst working in that factory. If there was nothing pressing in the factory in District F in China, he would take his time off during the week and visited Hong Kong.

(e) Company E supplied its products to Company H. The products were eventually shipped to Country M. Company H sent its staff to District F in China to discuss about shipping, packaging and sales. No meeting was ever held in Hong Kong. At no time did Company B send any of its staff to the factory in District F in China.

(f) He had a lot of personal matters to attend to whilst he was in Hong Kong. He did not make any telephone call to Company H in relation to the business of Company E.

(g) His responsibility subsequently extended not only to the factory in District F in China but to another factory in District N in China.

(h) Company E reimbursed Company B for salary paid to him in Hong Kong. He has no knowledge as to the reasons why the personnel department of Company B should have handled his leave entitlements in the manner as set out in the letter dated 26 January 1996.

(i) He obtained from Company B its 27 February 1998 letter to the Revenue. He

did not read that letter. He explained that Company B was wholly unaware of the operation in District F in China.

(j) He was approached by his former boss in Company B who indicated to him that there was good prospect in the construction industry and they needed good sales representative. He therefore returned to work for Company B.

(k) He could give no explanation as to why he only paid individual income tax in China as from 1 January 1997.

20. According to Mr G:

(a) He needed urgent assistance to tackle Company E's raw materials and electricity problems. The Appellant came from a village near Company E. He invited the Appellant to join Company E.

(b) The Appellant indicated that he would like to be paid in Hong Kong dollars. The arrangement with Company B was merely a mode of effecting payment.

(c) 90% of Company E's products were sold to Country M. The remaining 10% were sold to Country O. Company E marketed its own products.

(d) There was no need to attend any meeting in Hong Kong with Company H.

Our decision

21. The first question to be considered is whether the Appellant's income arose in or derived from Hong Kong from an employment of profit within the meaning of section 8(1) of the IRO. It is the Revenue's case that at all material times, the contractual relationship was between Company B and the Appellant. The Appellant was seconded by Company B to Company E. This is supported by the returns submitted by Company B and Company L; the correspondence between Company A/Company B/Company L and the Revenue; the application to and the grant of leave by Company B; the computation of the Appellant's length of service for the purpose of Company L's retirement scheme and the Appellant's own assertion when he applied for loan from Finance Company J. The Appellant however pointed out that the 1992 Agreement did not contain any provision conferring upon Company A and Company B the right to transfer the Appellant to a company in China. Furthermore the lines of business of Company B and Company E were wholly different, the former was engaged in the sale of construction materials whilst the latter in magnetic products. The Appellant maintained that the November 95 Letter was a wholly independent contract and that the arrangement with Company B was merely a payment mechanism.

22. We are not satisfied with the explanations given by the Appellant. Had the

arrangement between Company B and Company E been for the sole purpose of facilitating the Appellant's payment in Hong Kong currency, we see no justification as to why Company B and Company L should submit employer's returns to the Revenue and why Company L should include the Appellant's years of services with Company E in computing the Appellant's retirement entitlements. We also attach weight to the representation made by the Appellant to Finance Company J. We therefore find that the returns by Company B and Company L for the years of assessment 1995/96, 1996/97 and 1997/98 do correctly reflect the contractual position between those companies and the Appellant.

23. In relation to the years of assessment 1995/96 and 1997/98, there is no dispute that the Appellant is liable for salaries tax in respect of his earnings before 1 December 1995 and his earnings after 31 August 1997. The Appellant therefore did not render all the services in connection with his employment with Company B and Company L outside Hong Kong. His income whilst working with Company E during those years does not come within section 8(1A)(b)(ii) of the IRO. It is common ground that for each of the years of assessment 1995/96 and 1997/98, he was in Hong Kong well in excess of the 60 days' limit. The Appellant therefore cannot take advantage of the provisions in section 8(1B) of the IRO.

24. As far as the year of assessment 1996/97 is concerned, we accept the evidence of the Appellant that he rendered in District F in China all the services in connection with his employment. We further accept his evidence that his Hong Kong visits during weekdays were in return for his work during holidays in District F in China and that his stays in Hong Kong were for purposes wholly unconnected with his employment. In these circumstances, he is entitled to the exclusion as provided by section 8(1A)(b)(ii) of the IRO.

25. For these reasons, we allow the Appellant's appeal in respect of the year of assessment 1996/97 but dismiss his appeal in relation to the years of assessment 1995/96 and 1997/98.