INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/90

Salaries tax – source of income – Goepfert decision applied – section 8(1) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Edward Chow Kam Wah and Rowdget W Young.

Date of hearing: 19 April 1990.
Date of decision: 6 June 1990.

The taxpayer was employed by a Hong Kong based company which was a subsidary of an American company. He was employed as an internal auditor and performed his duties partly in Hong Kong and partly elsewhere. He argued that he was entitled to pay tax only on that part of his remuneration which related to services which he performed in Hong Kong.

Held:

The source of the income of the taxpayer was Hong Kong. The place where services are performed is not relevant. Goepfert decision applied.

Appeal dismissed.

Case referred to:

CIR v Goepfert [1987] 2 HKTC 210

S McGrath for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. The Taxpayer is a chartered accountant by profession. He appeals against salaries tax assessments as confirmed by the Commissioner in his determination dated 6 February 1990. The case for the Commissioner is that, having regard to the circumstances surrounding the Taxpayer's employment, he is liable to the 'basic' charge to tax imposed by section 8(1) of the Inland Revenue Ordinance. The case for the Taxpayer is that his liability

only arises under section 8(1A) in respect of income derived from services rendered in Hong Kong during the period in question.

2. The undisputed facts of the case are as follows:

(i) X Limited is a wholly owned subsidiary of Y Limited, a company resident in USA.

(ii) X Limited and the Taxpayer entered into a written contract of employment (dated 10 July 1986) whereby the Taxpayer was employed as 'internal auditor' subject to the terms and conditions set out in the letter.

(iii) The employment commenced on 28 July 1986.

(iv) The salary payable under the letter of employment was $16,500 per month, the salary being subject to review quarterly with increments based upon performance and 'the current salary structure'. Under the letter of employment, the Taxpayer became eligible, upon completion of six months service, for the Y Limited worldwide profit sharing scheme payable semi-annually. The Taxpayer also became qualified after completing twelve months service to participate in Y Limited's stock purchase plan.

(v) The Taxpayer also became entitled to certain other benefits available to the Y Group of companies, and other benefits which, on the terms of the letter of employment, were provided solely by X Limited.

(vi) The Taxpayer was part of an audit team responsible for the internal auditing and monitoring of Y 'entities' throughout the Asia/Pacific region. This meant that much of the Taxpayer's services as part of the internal audit team were performed outside of Hong Kong. Accordingly, in relation to the period covered by the first year of assessment, 28 July 1986 to 31 July 1987, the Taxpayer was working 95 days outside of Hong Kong. For the period 1 April 1987 to 6 February 1988 (when his employment ceased) the Taxpayer spent 182 days working outside of Hong Kong.

(vii) The Taxpayer's salary and expenses were paid by X Limited to him in the first place.

(viii) When the Taxpayer and his audit team completed an assignment overseas, the draft report and recommendations would be electronically mailed back to the Hong Kong office for 'fine-tuning'; that is to say, the report and recommendations would be reviewed by the audit manager in Hong Kong, and after discussion and revision the report would be finalised and despatched to the head office in USA. The audit manager occasionally did the reviewing whilst on assignment overseas.

3. In evidence, the Taxpayer stressed the fact that the internal audit team to which he belonged was 'insulated' from the management of X Limited. This was necessary in order to ensure the professional independence of the audit team. The audit team reported to head office in USA and not to X Limited. The function of X Limited was to act as a service company to the Y Group, providing managerial support. Thus, although the Taxpayer's salaries and expenses were paid by X Limited, X Limited was in turn reimbursed by head office by way of 'inter-company billing'.

4. In the course of his testimony, the Taxpayer said that two persons who were also employed in the audit department were assessed to salaries tax upon a 'time apportionment' basis; that is to say, chargeable only in respect of services rendered in Hong Kong. We declined to receive evidence concerning those two cases, as we considered our task to be confined to a consideration of the circumstances relevant to the Taxpayer's employment, not that of someone else. However, the fact that the Taxpayer felt that there had been discriminatory treatment by the Commissioner (whether justified or not) would naturally cause us to look at the circumstances of his own case with particular care.

5. The main thrust of the Taxpayer's case is this: although the written contract of employment was signed with X Limited, a Hong Kong based company, the reality of the employment was that all the services were rendered for the benefit of Y Limited based in the USA. As regards X Limited, the Taxpayer's contention was that it had nothing to do with the internal audit procedures undertaken by the audit team of which the Taxpayer was a member, nor did it have anything to do with the internal audit reports when these were completed. The internal audit team reported not to X Limited but to Y Limited in USA. We accept the Taxpayer's contention on this point.

6. Our difficulty in dealing with the Taxpayer's appeal is this: under section 68(4) of the Inland Revenue Ordinance, the burden of proving that the assessment appealed against is incorrect falls on the Taxpayer. It is for him to put facts before us to show that the assessments were wrong. The undisputed fact is that the Taxpayer signed a written contract of employment with X Limited, a Hong Kong based company; the contract was signed by both employer and employee in Hong Kong; the salary expressed in Hong Kong dollars was paid by X Limited to the Taxpayer in Hong Kong. Based upon these facts, it seems clear that the <u>income</u> from the Taxpayer's employment, in terms of section 8(1) of the Inland Revenue Ordinance, 'arose in' or 'was derived from' Hong Kong. The Taxpayer argued that although the payment of salary and expenses was effected by X Limited, this was merely a matter of 'internal billing' and that ultimately the salary and expenses were charged to Y Limited in the USA. Assuming that to have been the case (and there was no evidence of the internal bookkeeping put before us) it does not detract from the fact that <u>legal liability</u> for such payments fell on X Limited, and on X Limited alone. Some of the other fringe benefits of the Taxpayer's employment were computed by reference to the Y Group, but ultimate legal liability for such benefits also fell upon X Limited, the Hong Kong company. In these circumstances, it is difficult to give much weight to the 'inter-company billings' as between X Limited and Y Limited regarding the Taxpayer's salary and expenses.

7. The Taxpayer, in the course of his submission, stressed the fact that the bulk of his services were rendered at the place where the various Y 'entities' conducted their business, that is to say outside Hong Kong. It is important to note however that the question under section 8(1) of the Ordinance (the charging section) is not: where were the services rendered by the employee? It is: where did the income arise?

8. In the course of the hearing, we were referred to the case of CIR v Goepfert [1987] 2 HKTC 210 and in particular to the passage at page 236 to this effect:

> ' As a matter of statutory interpretation I am unable to escape the conclusion that, although section 8(1) must be construed in the light of and in conjunction with section 8(1A), section 8(1A)(a) creates a liability to tax additional to that which arises under section 8(1). It is an extension to the basic charge under section 8(1). If it were otherwise, section 8(1A)(a) would be virtually otiose and section 8(1A)(b) completely unnecessary. It follows that the place where the services are rendered is not relevant to the enquiry under section 8(1) as to whether income arises in or is derived from Hong Kong from any employment. It should therefore be completely ignored'.

9. We are, of course, bound to adopt the construction of the statutory provisions placed thereon by McDougall J in the Goepfert case. In any case, it seems to us to be plainly correct. If income arising from services rendered in Hong Kong is deemed by statutory enactment to be 'income arising in or derived from Hong Kong' (which is what section 8(1A)(a) says), and if the statute further exempts from the charge persons who render outside Hong Kong all the services in connection with their employments, even though in all other respects the source of the income could be said to be within Hong Kong, it must follow as a matter of logic that the place where the services are rendered is wholly irrelevant to the charge under section 8(1) of the Ordinance.

10. This renders the identification of the source of income much easier under section 8(1). Having put to one side the place where the Taxpayer rendered his services as being irrelevant to our consideration, and placing little weight upon the internal arrangements within the Y Group of companies for the final recognition of salaries and expenses attributable to the Taxpayer, it seems to us quite clear that the income from the Taxpayer's employment arose in Hong Kong. This appeal is accordingly dismissed.