Case No. D20/09

Salaries tax – whether the sums received were cash allowance or refund of rents – sections 8(1), 9(1) and 61 of the Inland Revenue Ordinance ('IRO') – the test to determine whether a payment was a rental refund.

Panel: Colin Cohen (chairman), Fred Kan and David Kwok Sek Chi.

Dates of hearing: 25 May and 1 June 2009.
Date of decision: 28 July 2009.

The Taxpayer and his wife owned Company B. Company B purchased the Flat which was rented by the Taxpayer. The Employer of the Taxpayer reported that the Flat was 'Quarters provided by employer' and the total rent refunded to the Taxpayer was $510,000 and $503,410 for each tax year respectively. Inland Revenue Department raised additional assessments of salaries tax on the Taxpayer.

The Taxpayer claimed that it was the intent of the Employer to provide rental refunds and not cash allowances. The issue before the Board was to decide whether the sums of $510,000 and $503,410 received by the Taxpayer from his Employer for the two years of assessments respectively, are cash allowances chargeable to tax pursuant to section 9(1)(a) of the IRO or refunds of rent within the meaning of section 9(1A)(a) of the IRO.

The Taxpayer had decided not to attend the hearing and he would not be calling any evidence.

Held:

1. Section 8(1) of the IRO is the charging section for the salaries tax and provides that salaries tax shall be charged on income from employment. Section 9(1) of the IRO defines income from employment. Clearly this definition is non-exhaustive.

2. A place of residence shall be deemed to be provided by the employer for a rent equal to the difference between the rent payable or paid by the employee and the part thereof paid or refunded by the employer, and such payment or refund shall be deemed not to be income.

3. Section 9(2) provides that the rental value of any place of residence shall be deemed to be 10% of the income as defined in section 9(1)(a) of the IRO after deducting certain outgoings and expenses. Section 61 empowers an assessor to disregard an artificial or fictitious transaction. The burden of proof in respect of this matter falls squarely on the shoulders of the Taxpayer.

4. The test to determine whether a payment was a rental refund is to clearly ascertain the intention of the parties as at the time of the payment by the Employer. Whether the sum is income from employment or a refund of rent is a question of fact. The Board needs to ascertain the intention of the parties as at the time of the payment by the employer. It is quite clear that stamped tenancy agreements and rental receipts are not conclusive evidence of a genuine landlord and tenant relationship. However, the agreed terms and features stipulated in any tenancy agreements would obviously be of assistance. However, one has to have regard to the fact as to whether or not the rent was at a market rate and whether or not property tax would have been assessed and paid. This would be a consideration that the Board would take into account (CIR v Peter Leslie Page 5 HKTC 683; D38/04, IRBRD, vol 19, 304; Seramco Trustees v Income Tax Commissioner [1977] AC 287; Commissioner of Inland Revenue v DH Howe [1977] HKLR 436 and Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773 considered).

5. No evidence was submitted to support the Taxpayer's contention that it was the intent of the Employer to provide rental refunds and not cash allowances. From review of the relevant documents, the Board has no hesitation in coming to a conclusion that there was never any genuine landlord and tenant relationship between the Taxpayer and Company B. In the Board's view, payment of rent reduces or would reduce the amount of tax payable by the Taxpayer and hence, the Board has no hesitation in concluding that the tenancy agreement is commercially unrealistic and artificial in the context of section 61. The Board accepts the submission that the letting of the property to the Taxpayer was artificial and in turn has to be disregarded pursuant to section 61 of the IRO. The Taxpayer has not discharged the burden of proof imposed upon him by section 68(4) of the IRO.

6. The Board concluded that the sums are not refunds of rent but cash allowances which are in turn chargeable to salaries tax under sections 8(1) and 9(1)(a) of the IRO.

Appeal dismissed.

Cases referred to:

CIR V Peter Leslie Page 5 HKTC 683
D38/04, IRBRD, vol 19, 304
Seramco Trustees v Income Tax Commissioner [1977] AC 287
Commissioner of Inland Revenue v DH Howe [1977] HKLR 436
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773
D76/03, IRBRD, vol 18, 738
D13/07, (2007-08) IRBRD, vol 22, 365

Nigel Bedford Counsel instructed by Messrs Weir & Associates for the taxpayer.
Tsui Nin Mei and Yip Chi Chuen for the Commissioner of Inland Revenue.

Decision:

Introduction

1. On 6 March 2009, we handed down a Decision whereby we refused to accede to an application for this matter to be heard in the absence of the Taxpayer pursuant to section 68(2D) of the Inland Revenue Ordinance ('IRO') and therefore, pursuant to section 68(2B)(c), we dismissed the appeal.

2. The Taxpayer through Messrs Weir & Associates ('the Solicitors') applied to us pursuant to section 68(2C) to review our order. Section 68(2C) states as follows:

> '*If an appeal has been dismissed by the Board under subsection (2B)(c) the appellant may, within 30 days after the making of the order for dismissal by notice in writing addressed to the clerk to the Board, apply to the Board to review its order and the Board may, if satisfied that the appellant's failure to attend at the meeting of the Board for the hearing of the appeal was due to sickness or any other reasonable cause, set aside the order for dismissal and proceed to hear the appeal.'*

3. On 25 May 2009, the Taxpayer was represented by Mr Bedford of Counsel instructed by the Solicitors and he put forward to us various submissions for us to review our decision. During the course of the hearing, he indicated to us that the Taxpayer would be present in Hong Kong on 1 June 2009. Having regard to all the circumstances, we were prepared to exercise our discretion under section 68(2C) and in turn, set aside our order dismissing the appeal. It was agreed that the appeal would be heard on the following week, that is, on 1 June 2009 at 2.00 p.m. Various directions were then given by the Board.

4. On 1 June 2009, the hearing commenced. The Taxpayer was again represented by Mr Bedford. The Deputy Commissioner of Inland Revenue ('the Deputy Commissioner') was represented by Ms Tsui Nin-mei ('Ms Tsui'). Mr Bedford advised us that the Taxpayer had decided not to attend the hearing and he would not be calling any evidence.

The issue

5. The issue before the Board was for us to decide whether the sums of $510,000 and $503,410 received by the Taxpayer from his employer, Company A ('the Employer') for the years of assessment 1999/2000 and 2000/01 respectively, are cash allowances chargeable to tax pursuant to section 9(1)(a) of the IRO or refunds of rent within the meaning of section 9(1A)(a) of the IRO.

The agreed facts

6. The parties helpfully agreed various facts. We find these facts as agreed and now set them out as follows:

(a) The Taxpayer was employed by the Employer as a Senior First Officer at all relevant times.

(b) Company B purchased the Flat at Address C on 6 December 1996. Company B was owned 50% by the Taxpayer and 50% by his wife. Both were also directors.

(c) According to the terms and conditions of his employment with the Employer, the Taxpayer duly completed the Employer's Checklist for New House/Boat Owner Occupiers on 31 January 1997.

(d) By a duly stamped tenancy agreement for a term of 3 years commencing on 1 November 1998, the Taxpayer rented the Flat from Company B for a monthly rental of $43,500.

(e) The Employer, by its Employer's Returns for tax years ended 31 March 2000 and 31 March 2001 respectively, reported that the Flat was 'Quarters provided by employer' and the total rent refunded to the Taxpayer was $510,000 and $503,410 for each tax year respectively.

(f) Company B was assessed to profits tax for the tax years 1999/2000 and 2000/01. There have been no adjustments to those assessments.

(g) IRD on 13 September 2005 raised additional assessments of salaries tax on the Taxpayer for the tax years ended 31 March 2000 and 31 March 2001 of $74,500 and $71,864 respectively.

(h) By letter of 17 September 2005, the Taxpayer's tax representative, Fanny P Lai & Co, CPA, wrote to IRD to register formal objection to the additional assessments.

The relevant statutory provisions

7. Section 8(1) of the IRO is the charging section for the salaries tax and provides that salaries tax shall be charged on income from employment.

8. Section 9(1) of the IRO defines income from employment. Clearly, this definition is non-exhaustive and it states as follows:

'*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, …..

(b) the rental value of any place of residence provided rent-free by the employer …..

(c) where a place of residence is provided by an employer ….. at a rent less than the rental value, the excess of the rental value over such rent …..'

9. A place of residence shall be deemed to be provided by the employer for a rent equal to the difference between the rent payable or paid by the employee and the part thereof paid or refunded by the employer, and such payment or refund shall be deemed not to be income. Specifically, section 9(1A) of the IRO provides as follows:

'*(a) Notwithstanding subsection (1)(a), where an employer …..-*

(i) pays all or part of the rent payable by the employee; or

(ii) refunds all or part of the rent paid by the employee,

such payment or refund shall be deemed not to be income;

…..

> *(c) a place of residence in respect of which an employer ….. has paid or refunded part of the rent therefor shall be deemed for the purposes of subsection (1) to be provided by the employer ….. for a rent equal to the difference between the rent payable or paid by the employee and the part thereof paid or refunded by the employer …..'*

10. Section 9(2) provides that the rental value of any place of residence shall be deemed to be 10% of the income as defined in section 9(1)(a) of the IRO after deducting certain outgoings and expenses.

11. Section 61 empowers an assessor to disregard an artificial or fictitious transaction. That section provides as follows:

> *'Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'*

12. The burden of proof in respect of this matter falls squarely on the shoulders of the Taxpayer. Section 68(4) provides as follows:

> *'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

13. The key issue here for us to consider is whether or not the sums of $510,000 and $503,410 are cash allowances or if they are refunds of rent. If they are cash allowances, then they should be assessed in full under section 9(1)(a) of the IRO. If they are refunds of rent, then the relevant provisions of section 9(1A)(a)(ii) will be applicable and the Taxpayer should be assessed only on the rental value of the place of residence provided to him by the Employer in accordance with the relevant sections 9(1)(c), 9(1A)(c) and 9(2) of the IRO. The test to determine whether a payment was a rental refund is to clearly ascertain the intention of the parties as at the time of the payment by the employer. We were referred to the following authorities:

(a) CIR v Peter Leslie Page 5 HKTC 683;

(b) D38/04, IRBRD, vol 19, 304;

(c) Seramco Trustees v Income Tax Commissioner [1977] AC 287;

(d) Commissioner of Inland Revenue v DH Howe [1977] HKLR 436;

(e) Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773.

14. Whether the sum is income from employment or a refund of rent is a question of fact. We need to ascertain the intention of the parties as at the time of the payment by the employer. It is quite clear that stamped tenancy agreements and rental receipts are not conclusive evidence of a genuine landlord and tenant relationship. However, the agreed terms and features stipulated in any tenancy agreements would obviously be of assistance. However, one has to have regard to the fact as to whether or not the rent was at a market rate and whether or not property tax would have been assessed and paid. This would be a consideration that the Board would take into account.

15. We of course would need to have regard to the relevant provisions of section 61 of the IRO. In particular, we rely on the observations of Lord Diplock in Seramco Trustees v Income Tax Commissioner [1977] AC 287. Lord Diplock reviewed the provisions of section 10(1) of the Jamaican Income Tax Law 1954 which is very similar to section 61 of the IRO:

> '….. *It is only when the method used for dividend stripping involves a transaction which can properly be described as "artificial" or "fictitious" that it comes within the ambit of section 10(1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*
>
> *"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.'*

16. We also rely on the judgment of Cons J (as he then was) in Commissioner of Inland Revenue v DH Howe [1977] HKLR 436 at page 441. He stated as follows:

> '….. *What then are the arrangements and the circumstances in which they were made and carried out that I must examine in order to see whether or not they are artificial? Simply they are these. By two separate agreements the taxpayer effectively transferred all his existing and future earnings as an author to a limited company. The consideration in each case was valuable in the technical sense but by no stretch of the imagination otherwise. If that were all, the agreements would have been, as counsel for the Commissioner suggests, in the words of their Lordships (p.294) quite "unrealistic from a business point of view". But there is one other circumstance to consider. The limited company which is the beneficiary of the taxpayer's apparent generosity is controlled by the taxpayer himself. That was a fact found by the Board of Review and I assume it to mean that the taxpayer holds all or substantially all of the shares therein. In this situation it does not necessarily follow that the transactions are commercially unrealistic. The overall position remains the same. What the taxpayer loses on the roundabouts he makes up on the swings. Looked at purely from the aspect of gross income the transactions seem unnecessary and unproductive. But the taxpayer may well have other matters in mind. I find nothing on the face of things that makes the agreements artificial in the way that their Lordships approached the Seramco situation. To my mind they are artificial only in the sense e.g. that a limited company is artificial. It is not the product of nature, it is the outcome of man's inventive mind. I am satisfied that the Board of Review came to a correct conclusion on this question.*'

17. Woo JA in Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773 stated as follows:

> '*41. The term "commercially unrealistic" appears in CIR v Howe (1977) 1 HKTC 936 at p.952 in the sense of "unrealistic from a business point of view". We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree with the submission of Mr. Cooney, however, that commercial realism or otherwise can be one of the considerations for deciding artificiality. In the present case, the Board found as a fact that there was no "commercial reality in the transaction" and that there "simply was no commercial sense in the transaction"; thus it was open to the Board to reach the conclusion that the transaction was artificial under s.61.*'

18. As we have previously stated above, Mr Bedford took the position that there was no need for him to call any evidence and was not in a position to do so. The Taxpayer was not present.

19. The Taxpayer claimed in his Notice of Appeal that it was the intent of the Employer to provide rental refunds and not cash allowances. However, no evidence was submitted to support such a contention. However, having regard to the documents we have had sight of, it is quite clear that the Employer's intention at all relevant times was to pay the Taxpayer, an owner occupier, financial assistance to subsidize the mortgage payments for his purchase of his property through Company B, his company. The key facts are as follows:

(a) The Taxpayer applied for a housing assistance under the Employer's Owner Occupiers Housing Assistance Scheme and obtained a housing loan of $500,000 in the acquisition of the property through Company B.

(b) The Employer also confirmed that for the years of assessment 1999/2000 and 2000/01, the Taxpayer received housing assistance as an owner occupier and that the housing assistance was based on the monthly mortgage repayment subject to a specified limit. Clause 5 of the 'Accommodation & Rental Assistance Policy Agreement' (entered into by the Hong Kong Aircrew Officers' Association and the Employer on 2 July 1999) provides that the Employer was to provide house and boat owner occupiers with assistance in the form of a cash allowance based on the actual monthly mortgage payment of the house or boat. Hence, there can be no doubt that such sums paid to the Taxpayer were for his purchase of the property through Company B. Again, the Employer on 19 March 2001 clarified that the housing allowance payable to employees who were owner occupiers, irrespective of whether they had service companies or not, was to be reported by it as a cash allowance and in turn, this would be fully taxable. The change in tax reporting effective from 1 April 2001 did not affect the Taxpayer's access to housing assistance and the provisions of his employment contract or conditions of service and as such, his conditions of service remained unchanged.

20. It is also quite clear from our review of the relevant documents that we have no hesitation in coming to a conclusion that there was never any genuine landlord and tenant relationship between the Taxpayer and Company B. Mr Bedford accepted that he was not able to call any evidence nor was he able to deal with these particular matters when pressed to do so. In particular, it is quite clear that the tenancy agreement between Company B and the Taxpayer showed the following very unusual terms and features which one would never find in a normal arms length tenancy agreement:

(a) The landlord was to pay all utilities (gas, water, telephone and electricity in respect of the property);

(b) The stamp duty was borne by the landlord;

(c) The tenant was not required to pay any rental deposits;

(d) There was no termination clause governing the tenancy;

(e) The Taxpayer failed to provide any rental receipts issued by Company B; and

(f) The Taxpayer failed to show that the monthly rental of $43,500 for the property was at a prevailing market rate. Indeed, the monthly rental for leasing the property at $43,500 far exceeded the market rents of $5,700 (exclusive of rates and management fees and on an unfurnished basis) as indicated by the Commissioner of Rating and Valuation, that is, the rental included in the lease was 660% more than the market value. Hence, we accept the submissions by Ms Tsui that the purported rents of the property were excessive and commercially unrealistic.

21. Mr Bedford in his submissions took the view that section 61 was not applicable due to the fact that (i) 'the impugned transaction(s)' must be the Employer' s payment of rental refunds to the Taxpayer; and (ii) the transaction does not reduce the amount of tax payable by the Taxpayer because section 9(1A)(a) deems that where an employer pays all or part of the rent paid by the employee such payments are not regarded as income. Mr Bedford argued that whether the transaction is either artificial or fictitious and does not fall for consideration and therefore, the Deputy Commissioner cannot disregard the transaction arbitrarily and assess the rent refunds as cash allowance and assessable income. Mr Bedford drew our attention to two authorities, D76/03 and D13/07.

22. We have no hesitation in rejecting these submissions. The relevant transaction in this case is the entering into the tenancy agreement between Company B and the Taxpayer and the payment of rent in turn that was made by the Taxpayer to Company B.

23. In our view, payment of rent reduces or would reduce the amount of tax payable by the Taxpayer and hence, we have no hesitation in concluding that the tenancy agreement is commercially unrealistic and artificial in the context of section 61.

24. Our reasoning is that during the relevant years, Company B was under the control by the Taxpayer and his spouse. We have also previously indicated that the monthly rental of $43,500 far exceeded the true market rent of $5,700. We accept Ms Tsui' s submissions that the letting of the property to the Taxpayer was artificial and in turn has to be disregarded pursuant to section 61 of the IRO.

25. Therefore, we conclude that the sums are not refunds of rent but cash allowances which are in turn chargeable to salaries tax under sections 8(1) and 9(1)(a) of the IRO.

26. The Taxpayer has not discharged the burden of proof imposed upon him by section 68(4) of the IRO. Mr Bedford took the decision not to call evidence in support of any of the submissions that he attempted to put forward at the hearing.

27. Having therefore reviewed all the authorities and considered the submissions both of the Taxpayer and the Deputy Commissioner, we have no hesitation in dismissing the Taxpayer's appeal and upholding the relevant assessments for the years of assessment 1999/2000 and 2000/01.

28. Finally, we take this opportunity of thanking the parties for their assistance in respect of this matter.