Case No. D30/10

Salaries tax – housing benefit – property owned by the appellants as tenants-in-common – whether tenancy agreement genuinely made – sections 8(1)(a), 9(1)(a), 9(1A), 9(2), 61, 61A, and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Chow Wai Shun (chairman), Marianna Tsang Wai Chun and Yeung Eirene.

Date of hearing: 18 June 2010.
Date of decision: 23 November 2010.

The housing benefit schemes in the separate appeals of Appellant 1 and Appellant 2 (who are not immediate family members) involve the same Property (the Flat and the Carpark) owned by them as tenants-in-common.

Company F is a private limited company in Hong Kong. Appellant 1 was effectively the controlling mind of Company F.

The Appellants' acquisition of the Property was financed by the Loan granted by Bank G to Company F as borrower secured by a mortgage over the Property. The Appellants, as mortgagors, were made guarantors of the Loan.

By the Agreement, Company F agrees to take up the liability and obligations of the Loan whilst the Appellants agree to reimburse or indemnify Company F for any principal payment of the Loan and grant Company F the right to occupy, licence, rent or use the Flat.

During the years of assessment concerned, Company F leased the Flat to the Appellants individually under separate tenancy agreements at different rents. The Appellants applied for rental reimbursement from their respective employers in respect of the Flat. Company F was not required to pay any profits tax in each of those relevant years.

The assessor did not accept that there was any genuine landlord and tenant relationship between Company F and the Appellants respectively.

The Appellants objected to the additional assessments thus raised on them.

Held:

1. As owners, the Appellants have every legal right to occupy and use the Flat as their residence.

2. The involvement of Company F is unnecessary and far from genuine:

   - Company F could not, and did not, have any right over the ownership of the Flat.

   - The Loan, the liability thereunder; the Agreement or the related receivables from the Appellants was not disclosed in the audited financial statements of Company F for the relevant years.

   - Appellant 1 was effectively the controlling mind of Company F.

   - There is no evidence to show that the Appellants have attempted to secure the required prior written consent from Bank G for their granting to Company F the right to occupy, licence, rent or use the Flat after the drawdown of the Loan.

3. Even if Company F did have the right to rent the Flat out without paying any compensation to the Appellants, the purported tenancies between Company F and the Appellants were problematic and unusual, particularly:

   - All the purported tenancy agreements were not properly and duly stamped.

   - The Appellants were not immediate family members. Yet, in none of the tenancy agreements was it mentioned that the Appellants did not have an exclusive right to use or they agreed to share, and indeed shared, the Flat with another tenant.

   - There had not been any cogent evidence to support the high level of total purported rent charged on the Appellants which grossly exceeded the market rental of the Flat except that they tended to match the level of payments allowable by their respective employers as rental reimbursement.

4. The Board concluded that there had not been any payment of rent and hence the payments made to the Appellants by their respective employers cannot be held as refund for the purposes of section 9(1A):

   - The Appellants and Company F did not intend to create any legally binding relationship under the Agreement and/or the tenancies between them.

   - Further or alternatively, the Agreement and/or the tenancies were artificial. They should be disregarded pursuant to section 61.

   - At all relevant times, the Appellants were entitled to receive the same

amount of income from their respective employers irrespective of how much rent they had paid. Hence 'there was nothing in respect to which there could be a refund'.

- In the case of Appellant 2, it was stated on the claim form required by her employer that the employee 'is not the home-owner'. Appellant 2 was one of the co-owners of the Flat and should not have been eligible to claim any reimbursement.

Appeal dismissed.

Cases referred to:

CIR v Peter Leslie Page [2005] 5 HKTC 683
D8/82, IRBRD, vol 2, 8
Cheung Wah Keung v CIR [2002] 3 HKLRD 773
Seramco Superannuation Fund Trustees v Income Tax Commissioners [1997] AC 287
CIR v Howe (1977) 1 HKTC 936
D93/01, IRBRD, vol 16, 784
D77/99, IRBRD, vol 14, 528
D30/04, IRBRD, vol 19, 233
D5/06, IRBRD, vol 21, 147
Yick Fung Estates Ltd v CIR [2000] 1 HKLRD 381
CIR v Tai Hing Cotton Mill (Development) Ltd [2008] 2 HKLRD 40
CIR v HIT Finance Ltd [2008] 2 HKLRD 52

First taxpayer in person and for and on behalf of the second taxpayer.
Yip Chi Yuen, Chan Man On and Wong Pui Ki for the Commissioner of Inland Revenue.

Decision:

1. (a) Appellant 1 is the appellant in Appeal A1. The total amount of tax over two years of assessment in dispute is $121,771.

(b) Appellant 2 is the appellant in Appeal A2. The total amount of tax over four years of assessment in dispute is $342,103.

2. The housing benefit schemes in both appeals involve the same properties owned by the Appellants as tenants-in-common.

3. Appellant 1 appeared in person and for and on behalf of Appellant 2. He raised no dispute to the facts upon which the Determinations were arrived at and gave no further

oral evidence. On such basis, and having considered all documentary evidence sent to the Board before the hearing, we find the following facts as facts relevant to these appeals:

(a) (i) By an employment letter dated 1 October 1991 ('Employment Letter 1'), Company A offered and Appellant 1 accepted the position as Group Financial Controller with effect from 1 November 1991. Employment Letter 1 contained, inter alia, the following terms and conditions:

'REMUNERATION

The remuneration for the two months ending December 31, 1991 will be not less than HK$75,000.

The annual remuneration for the year ending December 31, 1992 will be not less than HK$550,000, such remuneration to accrue on a day-to-day basis and will include the following salary and other benefits:

1. twelve months' basic salary and a double pay;
2. payment of all rental, rates, management and service charges payable in respect of [the Appellant 1's] housing accommodation;

…

The annual remuneration will be payable in the following manner:

1. Basic salary of HK$21,000 per month and a double pay equal to the aggregate of one month basic salary and rental reimbursement;
2. Rental reimbursement of HK12,000 per month;
3. Other benefits will be reimbursed or provided to [Appellant 1] as when [Appellant 1] submits the relevant supporting documents for such expenses so that the total annual remuneration will make up to not less than HK$550,000. In the event that the total other benefits claimed does not make up the annual remuneration to not less than HK$550,000, the shortfall will be payable to [Appellant 1] as an additional bonus. …'

(ii) (1) By an employment letter dated 19 January 1996 ('Employment Letter 2'), Company B offered and Appellant 2 accepted the position as deputy general manager for a fixed term of 3 years from 1 January 1996 to 31 December 1998. Employment Letter 2 contained, inter alia, the following terms and conditions:

‘ 1. Salary
Your basic salary will be HK$80,150 per month payable in arrears. …

2. Bonus
Your target bonus to be paid in December 1996 for the whole of the year will be 2 months’ salary, currently equal to HK$160,300. Should there be any salary adjustment during the year, the bonus will be pro-rated accordingly.

3. Housing Allowance
[Company B] will pay you a rent allowance of up to HK$31,500 per month. The cost of utilities, telephones and household insurance are for your own account. If your rent is less than the above allowance, you will receive the balance in cash.’

(2) By a letter dated 27 February 1997, Company B informed Appellant 2 that her remuneration package had been adjusted with effect from 1 January 1997 as follows:

‘ 1. Remuneration Package per annum : HK$1,800,220
2. Monthly Basic Salary : HK$ 86,150
3. Monthly Housing Allowance : HK$ 49,510
4. Year-End Bonus * : HK$ 172,300
*Bonus will be calculated on a pro-rata basis if there is a salary adjustment during the year.

All other terms and conditions of employment remained the same.’

(3) By a letter dated 31 December 1997, Company B notified Appellant 2 that the company had completed an annual salary review for 1997 and her remuneration package would be increased with effect from 1 January 1998 as follows:

‘ Basic Salary HK$95,590.00 x 12= HK$1,147,080.00
Housing Allowance HK$55,000.00 x 12= HK$ 660,000.00
Year-End Bonus * HK$ 191,180.00
Total Annual Package HK$1,998,260.00
*Year-End Bonus will be calculated on a pro-rata basis if there is any adjustment during the year.
....

All other terms and conditions arising out of your employment remained the same.'

(4) By a letter dated 1 January 1999 ('the Renewal Letter'), Company B renewed Appellant 2's employment as General Manager, Greater China for a fixed term of 2 years commencing from 1 January 1999. The Renewal Letter contained, inter alia, the following terms and conditions:

'1. Salary
Your basic salary will be HK$111,520 per month, payable in arrears…

2. Housing Allowance
[Company B] will pay you a rent allowance of up to HK$55,000 per month. The cost of utilities, telephones and household insurance are for your own account. If your rent is less than the above allowance, you will receive the balance in cash.
…

4. Car Allowance
[Company B] will provide car parking space during the employment period at the office building (currently at [Address C]). In addition, you will be reimbursed with car running costs and legitimate parking expense for your car at HK$3,000 per month.'

(5) On 31 March 2002, Appellant 2 ceased employment with Company B.

(b) By an Agreement for Sale and Purchase dated 12 November 1997, the Appellants acquired as tenants-in-common in equal shares the property at Address K ('the Flat') and Car Parking Space L ('the Carpark'), Address K at a total price of $12,000,000. The Flat and the Carpark are hereinafter referred to collectively as 'the Property'. On 3 March 1998, the Property was assigned to the Appellants upon completion of the purchase. On the same date and to finance the acquisition the Appellants as mortgagors, Company F as borrower and Bank G entered into a Tripartite Legal Charge ('the Legal Charge') whereby Bank G agreed to grant Company F a fixed loan facility of $8,400,000 ('the Loan') as secured by a mortgage over the Property. The Appellants were made guarantors of the Loan.

(c) The Legal Charge contained, inter alia, the following clauses:

‘ 2. COVENANT TO PAY

2.01 Covenant to Pay. In consideration of [Bank G] agreeing or continuing to grant general banking facilities to [Company F], [the Appellants] and [Company F] hereby covenant that they will pay to [Bank G] on demand the Secured Indebtedness.

……

5. REPRESENTATIONS AND WARRANTIES

5.01 [The Appellants] and [Company F] represent and warrant to [Bank G] that:

……

(c) the Property is beneficially owned by [the Appellants] free from any Charge except as created under or pursuant to this Deed and no person other than [the Appellants] has the use, occupation and possession of the Property or any part thereof.

……

6. UNDERTAKING

……

6.02 Mortgagors’ Negative Undertakings. [The Appellants] further undertake with [Bank G] throughout the continuance of this Deed that [the Appellants] will not, unless [Bank G] otherwise agrees in writing:

(a) sell, assign, transfer, sub-divide or otherwise dispose of or grant any option or right of first refusal over all or any part of the Property or any interest therein or attempt or agree to do any of the same;

……

(c) part with the use, occupation or possession of the Property or any part thereof in any way whatsoever whether by way of leasing, letting, sub-letting, licensing, lending, sharing, assigning or other means whereby any person other than [the Appellants] obtains the use, occupation or possession of the Property or any part thereof, irrespective of whether any rental or other consideration is given for such use, occupation or possession. …’

Nowhere in the Legal Charge was it mentioned that the Property was subject to any tenancy or licence.

(d) By an agreement dated 28 November 1997 (‘the Agreement’) made between the Appellants as the co-owners of the Flat of the one part and Company F of the other part, Company F agreed to take up the liability and obligations of the Loan for financing the purchase of the Flat. Under the Agreement Company F would be responsible for the monthly repayment of the Loan including both the principal and interest whilst the Appellants would reimburse or indemnify Company F for any principal

payment of the Loan and would grant Company F the right to occupy, to licence, to rent or to use the Flat. It was stated that the Appellants remained the legal owners of the Flat and retained the rights and benefits as the owner.

(e) In relation to Company F:

(i) It was incorporated as a private limited company in Hong Kong on 12 May 1992 in the name of Company H. It changed to the present name on 20 August 1992. At all relevant times, Company F had an issued and paid up share capital of $100, divided into 100 shares of $1 each. Appellant 1 and his mother held respectively 99 shares and 1 share in Company F. Appellant 1 and his mother were the only two directors of Company F.

(ii) In its Reports of the Directors for the year ended 31 December 1999 to 2001, Company F described its principal activity as 'property licencing and the provision of accounting, secretarial and taxation services'.

(iii) The detailed profit and loss accounts and profits tax computations of Company F for the years ended 31 December 1999 to 2001 showed, among others, the following particulars:

Year ended 31 December	1999	2000	2001
	$	$	$
Service income	306,690	250,420	-
Licence income	1,140,000	1,140,000	1,165,000
	1,446,690	1,390,420	1,165,000
Less: Expenses			
Licence expense*	(766,934)	(667,644)	(406,779)
Other expenses	(597,004)	(698,010)	(903,982)
	(1,363,938)	(1,365,654)	(1,310,761)
Profits/(Loss) before taxation	82,752	24,766	(145,761)
Assessable profits/(loss)	150,736	76,271	(140,936)
Less: Loss brought forward	(429,116)	(278,380)	(202,109)
Loss carried forward	(278,380)	(202,109)	(343,045)

*The licence expense represented loan interest payments.

(iv) The balance sheets of Company F as at 31 December 1999 to 2001 showed, among others, the following particulars:

Year ended 31 December	1999	2000	2001
	$	$	$

Non-current assets			
Furniture, fixtures and equipment	461,960	568,354	655,800
Motor vehicles	-	-	70,000
	461,960	568,354	725,800
Less: Depreciation	(269,465)	(411,553)	(547,865)
	192,495	156,801	
Current assets			177,935
Bank balance	92,523	43,553	
Current liabilities			88,380
Accrued charges	(8,455)	(2,000)	
Net current assets	84,068	41,553	
Non-current liabilities			(2,000)
Amount due to a shareholder	(150,113)	(47,138)	86,380
	126,450	151,216	
			(258,860)
			5,455

(v) The Loan and the Agreement were not disclosed or reflected in the audited financial statements of Company F for the years ended 31 December 1999 to 2001.

(f) (i) On diver dates, Company A filed employer's returns for the years ended 31 March 2000 and 2001 in respect of Appellant 1 showing the following particulars:

		1999/2000	2000/01
(a)	Capacity in which employed	Financial Controller	Financial Controller
(b)	Period of Employment	1-4-1999 – 31-3-2000	1-4-2000 – 31-3-2001
(c)	Income		
	Salary	$599,000	$626,000
	Allowance	-	$ 12,000
	Total	$599,000	$638,000
(d)	Place of residence provided		
	Address	The Flat	The Flat
	Period provided	1-4-1999 – 31-3-2000	1-4-2000 – 31-3-2001
	Rent paid to landlord by employee	$420,000	$420,000
	Rent refunded to employee	$420,000	$420,000

In his Tax Returns – Individuals for the years of assessment 1999/2000 and 2000/01, Appellant 1 declared the same amount of

employment income from Company A and same particulars of place of residence provided as above.

(ii) On diver dates, Company B filed employer's returns for the years ended 31 March 1999 to 2001 and a notification of cessation of employment for the year of assessment 2001/02 in respect of Appellant 2 showing, inter alia, the following particulars:

Year ended 31 March	1999 (i)	2000 (ii)	2001 (iii)	2002 (iv)
Capacity in which employed	General Manager, Greater China			
Period of employment	1-4-1998 – 31-3-1999	1-4-1999 – 31-3-2000	1-4-2000 – 31-3-2001	1-4-2001 – 31-3-2002
Income	$	$	$	$
Salary	1,203,870	1,374,240	1,374,240	1,338,240
Bonus	325,006	65,000	99,912	-
Leave pay	-	-	-	176,583
Gratuities	-	-	-	678,080
Car allowance	-	-	-	36,000
Total	1,528,876	1,439,240	1,474,152	2,228,903
Place of residence provided by employer				
Address	The Flat			
Period provided	1-4-1998 – 31-3-1999	1-4-1999 – 31-3-2000	1-4-2000 – 31-3-2001	1-4-2001 – 31-3-2002
Rent paid to landlord by employee	$720,000	$720,000	$720,000	$720,000
Rent refunded to employee	$660,000	$660,000	$660,000	$660,000

In her Tax Returns – Individuals for the years of assessment 1998/99 to 2001/02, Appellant 2 declared the same amount of employment income from Company B and same particulars of place of residence provided as above. Company B subsequently filed an additional notification of cessation of employment for the year of assessment 2001/02 in respect of Appellant 2 and reported that Appellant 2 received a share option gain of AUD$42,168.

(g) From the Commissioner of Rating and Valuation, it was known that the saleable area of the Flat was 102.7 square meter (or 1,100 square feet). The estimated open monthly market rent (exclusive of rates, government rent and management charges) of the Flat on an unfurnished basis for a 2-year term tenancy made on 3 March 1998 was $33,000. The estimated open monthly market rent (inclusive of rates, government rent but exclusive of management charges) of the Flat on an unfurnished basis were: (i) $34,500 as at 5 March 1998 for a term of 2 years; and (ii)

$28,500 as at 3 March 2000 for a term of either 2 years or 3 years.

(h) (i) On the basis of the returns in (f)(i) above the assessor raised on Appellant 1 the 1999/2000 and 2000/01 salaries tax assessments as below and Appellant 1 did not object.

	1999/2000	2000/01
	$	$
Income as above	599,000	638,000
Add: Value of residence provided [10% x Income]	59,900	63,800
	658,900	701,800
Less: Retirement scheme contribution	-	(4,000)
	658,900	697,800
Less: Basic allowance	(108,000)	(108,000)
Net Chargeable Income	550,900	589,800
Tax Payable thereon	83,153	89,766

(ii) On the basis of (f)(ii) above, on diver dates the assessor raised on Appellant 2 the 1998/99 to 2001/02 salaries tax assessments as below and Appellant 2 did not object.

Year of Assessment	1998/99		1999/2000		2000/01		2001/02	
	$		$		$		$	
Income as above	1,528,876		1,439,240		1,474,152		2,397,292	[1]
Add:								
Value of residence provided	92,887	[2]	83,924	[3]	87,415	[4]	95,082	[5]
Assessable income	1,621,763		1,523,164		1,561,567		2,492,374	
Less:								
Charitable donations	-		(500)		(1,000)		-	
Net Income	1,621,763		1,522,664		1,560,567		2,492,374	[7]
Tax Payable thereon[6]	243,264		228,399		234,085		373,856	

Note:
[1] $2,228,903 + AUD42,168 x $3.9933
[2] $1,528,876 x 10% - ($720,000 - $660,000)
[3] $1,439,240 x 10% - ($720,000 - $660,000)
[4] $1,474,152 x 10% - ($720,000 - $660,000)
[5] ($2,28,903 - $678,080) x 10% - ($720,000 - $660,000)
[6] Tax was charged at standard rate without allowance granted
[7] Pursuant to the Tax Exemption (2001 Tax Year) Order, the tax payable for the year 2001/02 was later reduced by $3,000 from $373,856 to $370,856.

(i) Subsequently it came to the assessor's notice that during the years of assessment concerned, Company F leased the Flat to the Appellants individually under separate purported tenancy agreements at different

rents. The Appellants applied for rental reimbursement from their respective employers in respect of the Flat. Enquiries were made to Company F, Company B and Appellant 2. Among other things, the following documents and information were provided.

(i) An unstamped tenancy agreement dated 3 March 1998 ('Tenancy 1') was entered into between Company F as landlord and Appellant 1 as tenant. Tenancy 1 provided that Company F agreed to let the Flat to Appellant 1 commencing from 16 April 1998 at a monthly rent of $35,000 inclusive of government rent and rates, management fees, telephone charges, utilities and cleaning charges. Tenancy 1 had no expiry date and no rental deposit was payable by Appellant 1. 24 rental receipts were issued by Company F covering the period from April 1999 to March 2001. All the receipts were signed by Appellant 1 on behalf of Company F.

(ii) For rental reimbursement claim over the period from 1 April 1998 to 31 March 1999, Company B was provided with an undated and unstamped tenancy agreement ('Tenancy 2A') between Company F as landlord and Appellant 2 as tenant. Tenancy 1A provided that Company F agreed to let the Flat to Appellant 2 for a term of 2 years from 5 March 1998 to 4 March 2000 at a monthly rent of $60,000 inclusive of rates and government rent with a rent-free period from 5 March 1998 to 18 March 1998. The utilities, cleaning and management fees were borne by Appellant 2. A rental deposit equivalent to two months' rent or $120,000 was payable by Appellant 2 to Company F. The agreement included provision of 2 water heaters, 3 air-conditioners, 2 lightings, 2 wardrobes and a sofa. 13 rental receipts covering the period from 19 March 1998 to 4 April 1999 were issued. They were signed by Appellant 1 without any mention of Company F.

(iii) For rental reimbursement claim over the period from 1 April 1999 to 31 March 2000, Company B was provided with another undated and unstamped tenancy agreement ('Tenancy 2B') between Company F as landlord and Appellant 2 as tenant. It provided that Company F agreed to let the Flat to Appellant 2 for a term of 2 years from 5 March 2000 to 4 March 2003 [which should have been March 2002 instead of March 2003 as stated in Tenancy 2B] at a monthly rent of $60,000 inclusive of rates and government rent. No furniture or electrical appliances were provided for. 12 rental receipts covering the period from 5 April 1999 to 4 April 2000 were issued. They bore the same signature but there was no mention of Company F and the name of the payer was left blank.

(iv) For rental reimbursement claim over the period from 1 April 2000 to 31 March 2001, Company B was provided with another unstamped tenancy agreement dated 20 February 2000 ('Tenancy 2C') between Company F as landlord and Appellant 2 as tenant. It provided that Company F agreed to let the Flat to Appellant 2 for a term of 2 years from 5 March 2000 to 4 March 2002 at the same rent inclusive of rates and government rent. The agreement included provision of 2 water heaters, 3 air-conditioners, 2 lightings, 2 wardrobes and a sofa. 13 rental receipts covering the period from 5 March 2000 to 4 April 2001 were issued. They were signed by Appellant 1 for and on behalf of Company F.

(v) For rental reimbursement claim over the period from 1 April 2001 to 31 March 2002, Company B was provided with, inter alia, a letter dated 1 March 2002 issued by Company F stating that Company F and Appellant 2 came to a mutual agreement to extend Tenancy 2C until 31 March 2002 in the same terms. 13 rental receipts covering the period from 5 March 2001 to 31 March 2002 were issued. They were signed by Appellant 1 with no mention of Company F.

(vi) For all rental reimbursement claims by Appellant 2, she was required by Company B to sign and submit a claim for which included a note that the employee 'is not a home owner'.

(j) Having examined the information available, the assessor did not accept that there was a genuine landlord and tenant relationship between Company F and Appellant 1 and Appellant 2 respectively. The monthly payment to the Appellants in each case was therefore considered cash allowance chargeable to tax.

(i) On diver dates, the assessor raised on Appellant 1 the following additional salaries tax assessments:

	1999/2000	2000/01
	$	$
Income	599,000	638,000
Rent refunded to employee	420,000	420,000
	1,019,000	1,058,000
Less: Retirement scheme contribution	-	(4,000)
	1,019,000	1,054,000
Less: Basic allowance	(108,000)	(108,000)
Net Chargeable Income	911,000	946,000
Less: Income previously assessed	(550,900)	(589,800)
Additional Net Chargeable Income	360,100	356,200
Additional Tax Payable thereon	61,217	60,554

(ii) On diver dates, the assessor raised on Appellant 2 the following additional salaries tax assessments:

Year of Assessment	1998/99	1999/2000	2000/01	2001/02
	$	$	$	$
Income	1,528,876	1,439,240	1,474,152	2,397,292
Rent refunded to employee	660,000	660,000	660,000	660,000
Assessable Income	2,188,876	2,099,240	2,134,152	3,057,292
Less: Charitable donations	-	(500)	(1,000)	-
Net Income	2,188,876	2,098,740	2,133,152	3,057,292
Less: Income previously assessed	(1,621,763)	(1,522,664)	(1,560,567)	(2,492,374)
Additional Net Income	567,113	576,076	572,285	564,918
Additional Tax Payable thereon	85,067	86,412	85,887	84,737

(k) The Appellants objected to the additional assessments but failed.

The Appellants' grounds of appeal and the issue for the Board

4. The grounds of appeal in these two appeals are by and large identical. In sum, the Appellants argued that the sums in dispute were rent refunds because there were rental reimbursement schemes arranged by their respective employers and there were policies and procedures to control the rental refund benefits.

5. The issue for the Board to decide is whether in both appeals, the monthly payment received by the Appellants from their respective employers during the years of assessment in dispute was a refund of rent and in which case only the notional rental value would be chargeable or the whole amount was income chargeable to salaries tax.

The Law

6. The relevant provisions of the Inland Revenue Ordinance are set out below:

(a) Section 8(1)(a) provides:

'*Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of her income arising in or derived from Hong Kong from the following sources-*

(a) any office or employment of profit; and

(b) …'

(b) Section 9(1) provides:

'*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 or an associated corporation;*

(c) *where a place of residence is provided by an employer or an associated corporation at a rent less than the rental value, the excess of the rental value over such rent;*

(d) *…'*

(c) Section 9(1A) provides:

'*(a)* *Notwithstanding subsection (1)(a), where an employer or an associated corporation-*

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

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

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

(b) *a place of residence in respect of which an employer or associated corporation has paid or refunded all the rent therefor shall be deemed for the purposes of subsection (1) to be provided rent free by the employer or associated corporation.*

(c) *a place of residence in respect of which an employer or associated corporation has paid or refunded part of the rent therefor shall be deemed for the purposes of subsection (1) to be provided by the employer or associated corporation 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 or associated corporation.'*

(d) Section 9(2) provides:

'*The rental value of any place of residence provided by the employer or an associated corporation shall be deemed to be 10% of the income as described in subsection (1)(a) derived from the employer for the period during which a place of residence is provided…'*

(e) Section 61 provides:

'*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.*'

(f) Section 61A provides:

'*(1) This section shall apply where any transaction has been entered into or effected… and that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as 'the relevant person'), and, having regard to-*

(a) the manner in which the transaction was entered into or carried out;

(b) the form and substance of the transaction;

(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;

(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;

(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;

(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and

(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,

it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other person, to obtain a tax benefit.

(2) Where subsection (1) applies, the power conferred upon an assessor under Part X shall be exercised by an assistant commissioner, and such assistant commissioner shall, without derogation from the powers which he may exercise under that Part, assess the liability to tax of the relevant person-

(a) as if the transaction or any part thereof had not been entered into or carried out; or

(b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.

(3) In this section-

"tax benefit" means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof;

"transaction" includes a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable or intended to be enforceable, by legal proceedings.'

(g) Section 68(4) provides:

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

7. The Respondent cited the following cases and extracts in the written submissions:

(a) In relation to sections 9(1)(a), 9(1A) and 9(2), CIR v Peter Leslie Page [2002] 5 HKTC 683 where Mr Recorder Chan SC rejected an employee's claim that her housing benefit provided by her employer in her employment contract was a refund of rent even though the employee had rented a property and incurred rental expenses.

(i) *'17. … I agree with the notion that refund should mean "pay back" or "reimbursement". Hence unless the taxpayer had made a payment as rent, there could be no question of her receiving any refund of rent from her employer. Likewise, if the employer merely made a payment to the employee without regard or reference as to whether the employee had made any payment for rent or not, it would be difficult to see how it could be said that the payment made by the employer could amount to a refund of rent paid by the employee. … A*

"refund" of rent would connote that the person receiving the "refund" has already spent her own money to pay rent …'

(ii) *'18. … While I agree that the terms of the contract is a very useful starting point and is a very weighty factor in deciding the nature of the payment, I think it would be wrong to say that the terms of the contract would be the sole test. Again while I agree that the intention of the parties is the real test, the relevant point of time is the time of the payment of the money by the employer and not the point of time when the parties entered into the contract of employment.'*

(iii) *'20. … the arrangement between him and the employer was such that he was entitled to the same housing benefit even if he did not rent any property or rented a property at a rent lower than the amount of housing benefit stated in the appendix. This would effectively mean that he would be entitled to be paid the same sum of money even though he had not made any payment of rent himself. In such circumstances, it would be difficult to see how the housing benefit received by him could be a rental refund because the arrangement could be that there was nothing in respect to which there could be a refund. …'*

(b) Also in relation to sections 9(1)(a), 9(1A) and 9(2), D8/82, IRBRD, vol 2, 8 where the Board pointed out at page 10:

'To label a payment in addition to salary as a "housing allowance" or to split a taxpayer's remuneration into two parts and call one part a "housing allowance" would not necessarily render that portion so described as exempt income. It is quite capable of falling into the category of a perquisite or allowance so as to be taxable by virtue of section 9(1) of the [IRO].'

(c) In relation to section 61, Cheung Wah Keung v CIR [2002] 3 HKLRD 773 where the Court of Appeal stated:

(a) *'40. The meaning of "artificial or fictitious" has been dealt with in Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287, where Lord Diplock giving the judgment of the Privy Council stated at p. 298:*

"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… 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 statue 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.'

(b) *'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… that commercial realism or otherwise can be one of the considerations for deciding artificiality.'*

(d) Further in relation to the meaning of the words 'artificial' and 'fictitious' in section 61 of the IRO, D93/01, IRBRD, vol 16, 784 where the Board summarized the following principles drawn in D77/99, IRBRD, vol 14, 528:

(i) The words are to be given the ordinary meaning.

(ii) 'Artificial' is wider than 'fictitious'. According to the Shorter Oxford Dictionary, 'artificial' means not natural, a substitute for what is natural or real, feigned, fictitious. 'Fictitious' means artificial, counterfeit, sham, not genuine, feigned, assumed, not real, imaginary, of the nature of fiction.

(iii) All the circumstances of the particular transaction have to be examined if it is artificial or fictitious.

(iv) A transaction is not artificial by reason of the fact that it is between related parties or it is intended for tax planning purpose. However, if there is no commercial sense for the transaction and no purpose for the transaction other than for tax benefit, it may well fit the expression 'artificial'.

(e) As an illustration of 'artificial' or 'fictitious' transaction, D30/04, IRBRD, vol 19, 233 where the Board did not accept the housing assistance received by the taxpayer from his employers were rental refunds and said at page 249:

'*28.* *… we do not accept that the Taxpayer and Company B intended to create a legally binding sub-tenancy agreement between them in respect of the Property. Our reasons are as follows:*

(a) *The Property was at all material times owned by the Couple as joint tenants. The Taxpayer has every legal right to use the Property as her residence. We accept that there is absolutely no need for the Couple to let the Property to Company B and for Company B to sub-let the Property back to the Taxpayer in the roundabout way before the Taxpayer could use the Property as residence for himself and her family.*

…

(c) *… unusual to see a tenancy agreement without a provision of rental deposit. …*

29. *… In our view, the issue of rental receipts … and treatment of the housing assistance received by the Taxpayer and his connected parties in their tax returns are self-serving.*

…

33. *… we would have concluded that … the letting arrangement between the Couple and Company B and the sub-letting arrangement between Company B and Taxpayer were artificial and fictitious.'*

(f) As an illustration of commercial realism, D5/06, IRBRD, vol 21, 147 where the Board held that the sum received by the taxpayer was a cash allowance instead of rent refund and said in page 152:

'*24.* *… the monthly rent of HK$90,000.00 was double the market rent. We have no difficulties in coming to the conclusion that the purported tenancy was not negotiated at arm's length and had no commercial reality or sense about it.*

25. *… there was no purpose for the alleged letting of the Address D property by Company E to the Taxpayer other than to obtain a tax benefit.'*

(g) In relation to section 61A of the IRO, Yick Fung Estates Ltd v CIR [2000] 1 HKLRD 381 where the Court of Appeal stated in page 399:

'*There is no, and has, as far as can be seen, been no, dispute between the parties that the words "… it would be concluded that…" and indeed, the structure of sub-s.(1) lead to the conclusion that the tests set out in s.61A have to be applied objectively.*

…

In this Court, there was some discussion as to whether it is necessary for more than one item in matters (a) to (g) [of section 61A(1)] to indicate the sole or dominant purpose for it to be possible that that conclusion be arrived at. In my view, the posing of the question itself possibly indicates and erroneous approach to the section. Clearly, what must happen is that those matters must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit. It may be observed, for example, that one or other of the matters in (a) to (g) may be strongly or weakly suggestive of a purpose of obtaining a tax benefit or may be strongly or weakly suggestive of some other purpose. The Assistant Commissioner who undertakes such task has to use her own common sense and apply the results of her deliberations in respect of each matter and come to an overall conclusion.'

(h) Also in relation to section 61A, CIR v Tai Hing Cotton Mill (Development) Ltd [2008] 2 HKLRD 40 where the Court of Final Appeal stated:

'*13. Did the transaction have the effect of conferring a tax benefit? A benefit is something which makes your position better. The word invites a comparison…*

14. … s.61A raises a straightforward question of causation and comparison. If the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit…

…

26. … But these parties were plainly not dealing at arm's length. They were parent and subsidiary; in economic terms the same enterprise under the same direction. The notion that each was trying to get the best deal it could is quite unreal. The land was simply being passed from one pocket to the other. It did not matter to the parties what the terms of sale were. In economic terms, the result would have been exactly the same whatever the taxpayer agreed to pay. It is therefore necessary to ask why the parties

chose the price formula which they did rather than fixing it in some other way.

…

28. … The question in s.61A is not what the purpose of the parties actually was, but the objective question of what would be concluded from a consideration of the various matters listed in paras. (a) to (g).'

(i) On the point of 'tax benefit', CIR v HIT Finance Ltd [2008] 2 HKLRD 52 where the Court of Final Appeal added:

'17. … A tax benefit simply means a difference favourable to the taxpayer between her tax liability computed on one basis and her liability computed on a different basis.'

Our analysis and decision

8. The Flat was at all material times owned by the Appellants as tenants-in-common. As owners, they had every legal right to occupy and use the Flat as their residence. There is no need for the Appellants to enter into the Agreement with Company F and rent back the Flat.

9. Regarding the involvement of Company F, the Appellants claimed, and we recite verbatim, as follow:

(a) '… [At the time the Appellants purchased the Flat], Hong Kong property market and financial market were volatile under the impact of the Asian financial crisis. Property price dropped. Banks tightened their credits, increased prime rate and interest margin. Lots of home owners had their property value below mortgage loan liability amount.'

(b) '… [Appellant 1] had good corporate commercial banking relation with [Bank G]. At the same time, [Company F] had previous property investment with loan finance from [Bank G] and therefore regarded as an established customer for [Bank G]. As a result, [Bank G] was willing to grant the Loan facility to [Company F] … However, [Bank G] could not offer the loan to [the Appellants] as retail customers. That was something beyond [their] controls. …'

(c) 'The paramount motive for [the Appellants] to enter into the Agreement was to secure a loan facility in a timely manner to ensure sufficient funds available for the completion of the purchase of the Flat. …'

(d) 'If [the Appellants] had planned to have a tax arrangement for our

holding of the Flat, [they] could have used a limited company to buy the Flat instead of using personal name. If [the Appellants] could have got credit from other banks… [they] had done so. But the fact was that [they] failed to secure another credit. [The Appellants] would not be the owners of the Flat if the Loan was not obtained through [Company F] in the first place.'

(e) 'The prime motive for [Company F] to enter into this arrangement was to earn reasonable profits without exposing to excessive risks.'

10. In short, the Appellants attempted to distinguish themselves from employees who are owner-occupiers. The gist of their claim was that they would not have become owners of the Flat in the first place without Company F securing the Loan to finance the purchase, and for that they had to have entered into the Agreement with Company F by which they gave away their right to use the Flat.

11. The Hong Kong Monetary Authority has been issuing monthly press releases including statistics of residential mortgage lending in Hong Kong, which show that mortgage lending rose rapidly in July 1997 to reflect a sudden boom of the property market just before the handover. That was, however, followed by an immediate and steep downward trend. In our view, that should have been noticeable by the Appellants when they were considering the purchase of the Flat. They did not put forward any pressing needs for the purchase at that time.

12. The Appellants said in their Notices and Statements of Grounds of Appeal that Appellant 1 'approached several banks including [Bank G] and [Bank J]'. Only two banks which are also the note-issuing banks were named, one of which eventually lent the money on the basis of, as alleged by the Appellants, the established and 'good corporate commercial banking relation' with Company F. It is not shown to us clearly enough the effort put into the search for alternatives and the extent of difficulty encountered in the process. What the Appellants had said is at best, in our view, just self-serving.

13. Even if we accepted that Company F had to be involved as borrower in the Loan, it did not necessarily lead to the conclusion of the Agreement to the extent of complexity it stood. The Agreement required the Appellants to 'reimburse or indemnify [Company F] for any principal payment of the Loan'. The rights granted to Company F under the Agreement and possible income derived therefrom are, in our view, purported to cover the interest component of the Loan and as its reasonable profits. Those came together with, however, liabilities in respect of the Flat as mentioned under the Agreement. To simplify the matter, Company F could have asked the Appellants to reimburse or indemnify it for the payment of the principal and the interest of the Loan together with a mark-up. That appears to us better fit with the prime motive of Company F which was said to 'earn reasonable profits without exposing to excessive risks.' After all, Company F could not, and did not, have any right over the ownership of the Flat and as acknowledged by the Appellants in their Notices and Statements of Grounds of Appeal, there would be no extra value for Company F to have a second charge over the Flat since Bank G had already had the

first.

14. There are unfavourable indicators on how genuine the involvement of Company F was.

(a) None of the Loan, the liability thereunder, the Agreement or the related receivables from the Appellants was disclosed, reflected or even noted in the audited financial statements of Company F for the relevant years.

(b) Appellant 1 was effectively the controlling mind of Company F. In all relevant documents, Appellant 1 appeared as the authorized signatory of Company F.

(c) In accordance with clause 5.01(c) of the Legal Charge, the Appellants and Company F represented and warranted that no person other than the Appellants had the use, occupation or possession of the Flat. Further, clause 6.02(c) of the Legal Charge required prior written consent from Bank G for the Appellant's parting with the use, occupation or possession of the Flat. However, by way of the Agreement the Appellants had agreed before the Legal Charge was executed to grant Company F the right to occupy, to licence, to rent or to use the Flat after the drawdown of the Loan. While the Agreement also envisaged and therefore made Company F to bear the possible consequence on the interest rate and other related expenses in connection with the Loan that might be caused by such grant of right, we find no evidence to show that the Appellants have attempted to secure the required consent.

15. Even if we also accepted that the Agreement had to have been concluded as it stood and hence Company F had the right under the Agreement to rent the Flat out in any manner so long as its conduct is legal without paying any other compensation to the Appellants, the purported tenancies entered into between Company F and the Appellants were problematic and unusual with a number of incongruities.

(a) All the purported tenancy agreements were not properly and duly stamped and, as the Respondent put it, pursuant to section 15(1) of the Stamp Duty Ordinance they could not be received in evidence in this hearing. Furthermore, the fact that they were not stamped can at least be an unfavourable indicator of how genuine the alleged landlord and tenant relationship was.

(b) The Flat was let to the Appellants who were not immediate family members to one another at the same time under separate tenancy agreements. There was, however, no mention in any of the tenancy agreements that the Appellants agreed to share, and indeed shared, the Flat with another tenant and that they did not have an exclusive right to use the Flat. Appellant 1 submitted, in both his submission and his reply,

that he and Appellant 2 were financially independent. In his reply, Appellant 1 further said that Company F preferred to have two separate tenancies and vis-à-vis the Appellants, Appellant 2 would prefer to have more space, and in particular, the use of more wardrobes. However, all those were not corroborated by evidence.

(c) Tenancy 2A and Tenancy 2B were not dated.

(d) Tenancy 1 and Tenancy 2A did not require the payment of rental deposit but Tenancy 2B and Tenancy 2C did.

(e) The mistake of the period of tenancy in Tenancy 2B, which was alleged as a typo.

(f) Tenancy 2B and Tenancy 2C covered the same period of tenancy but in different format and terms particularly in respect of furniture and electrical appliances provided under the respective tenancies.

(g) Discrepancies and omissions could be found in some of the purported rental receipts submitted in respect of Appellant 2.

16. In relation to the purported rental charged, the total monthly amount paid by the Appellants grossly exceeded the market rental of the Flat. We note the Appellants' submission in this regard in their notices and statements of grounds of appeal:

(a) 'The circumstances to the arrangement are unique itself. … [It] would not be commercially sensible for [Company F] to charge the rental simply based on the market value plus other running costs. The risk factor in interest rate movement and a reasonable return had to be taken into account by [Company F]. …'

(b) 'The setting of the total rentals from Company F's perspective has taken into consideration of:

i. evaluation of the counter party risk (as Company F knew the credit worthiness and financial strength of [the Appellants], Company F considered the risk acceptable);

ii. volatility of interest rate (interest was likely to go upwards with bank credit crunch and sufficient cushion had to be built in the charging the rentals to [the Appellants]);

iii. confidence level in the property and financial market (although property price would decrease, there is a buffer of 30% for the Flat purchase price of HK$12,000,000 and the Loan of HK$8,400,000 and banks also cared more about repayment capability);

iv. the furniture, fixtures and fittings and other additional running costs incurred in the transaction;

v. its rights, liabilities and obligations under the Loan and the Agreement;

vi. to get a reasonable return out from the arrangement.'

17. The Respondent made observation on each of the alleged factors above in his written submission.

i. 'If the counter party risk is low, the rent is expected to be set at a lower level in open market.'

ii. 'If the market expected an increase of interest rate, the property price is expected to fall and the rent is expected to set at a lower level in open market.'

iii. Ditto.

iv. 'The more furnished equipment it provided, the higher the market rent.'

v. 'As the Appellants were the guarantors of the Loan, [Company F]'s liabilities and obligations were minimal and the rent is expected to be set at a lower level in open market.'

vi. 'The setting of rent should be determined by market force but not the rate of return of the landlord.'

On these observations, the Respondent concluded that there had not been cogent evidence to support the high level of purported rent charged. On the whole, we accept the Respondent's conclusion and we do not think it necessary to state if we agree on each and every of the observations above.

18. The Flat was furnished under Tenancy 2A and 2C, not Tenancy 1 and Tenancy 2B. It was unusual, odd and even absurd. The furniture and electrical appliances comprised only '2 heaters, 3 air-conditioners, 2 lightings, 2 wardrobes and sofa'. We cannot accept that the Appellant 1's comment made in his reply at the hearing that the Flat was 'well furnished' to warrant such a high rent.

19. In his reply, Appellant 1 also mentioned that Company F cared much about the total amount of fees receivable from the Appellants, which we could understand. However, during the relevant years, the annual total purported rent received by Company F remained more or less constant at $1,140,000 while the annual interest expenses paid by Company F during the same period decreased from $766,934 to $192,410. It was surprised to note that

neither of the Appellants had attempted to ask for a review of the purported rent and hoped for any downward adjustment, when the interest expenses had gone down so significantly.

20. The Appellants attempted to argue in their notices and statements of grounds of appeal that the Inland Revenue Department might have challenged Company F if Company F had charged a lower purported rent, or adjusted the purported rent in accordance with the interest expense, and thus incurred a loss (or a lower profit margin). However, we note from its profits tax computation that Company F was not required to pay any profits tax in each of those relevant years after charging various expenses against such income and utilizing its previous loss brought forward.

21. The observation we have, in relation to the level of the respective purported rentals charged on the Appellants, is that they tended to match the level of payments allowable by their respective employers as rental reimbursement.

22. Having considered all the evidence made available to us and from the analysis above, we find that the Appellants have not satisfied the burden of proof under section 68(4) in showing to us on the balance of probabilities that the arrangement was genuinely made. We cannot accept that the Appellants and Company F intended to create a legally binding relationship under the Agreement and/or the tenancies between them, with Company F as the landlord, in respect of the Flat which were indeed owned by the Appellants. As such, there had not been any payment of rent and hence the payments made to the Appellants by their respective employers cannot be held as refund for the purposes of section 9(1A).

23. Further or alternatively, and in light of the legal principles enunciated in D77/99, we accept the Respondent's submission that the Agreement and/or the tenancies were artificial. Since the artificial transactions helped reduce the amount of tax payable by the Appellants, they should be disregarded pursuant to section 61. The same conclusion as above would be reached and that is that the payments made to the Appellants by their respective employers cannot be held as refund for the purposes of section 9(1A).

24. Even if we were wrong in any part of our analysis above, the payments made to the Appellants by their respective employers would not be refund for the purposes of section 9(1A) in light of the decision of and principles articulated in CIR v Peter Leslie Page. The reason for this is that at all relevant times, both the Appellants were entitled to receive the same amount of income from their respective employers irrespective of how much rent they had paid and in such circumstances, 'there was nothing in respect to which there could be a refund'. In the case of Appellant 2, we are also mindful of the note on the claim form required by her employer which stated that the employee 'is not the home-owner'. At the time of the reimbursement, the employer had no intention to make rental refund to staff who was the owner of the leased flat. Appellant 2 was one of the co-owners of the Flat and should not have been eligible to claim any reimbursement.

25. We do not see it necessary to consider section 61A in any detail. Had it been necessary for us to do so, we would accept the Respondent's submission in this regard, in light of all the evidence made available to us, from the analysis above (and probably in

particular paragraph 21 above) and the relevant authorities cited to us.

26. For the aforesaid reasons, the appeals must fail. Accordingly, we dismiss the appeals of the Appellants and confirm the Determination and the additional assessments in paragraph 3(j) above.