Case No. D31/85

Board of Review:

Robert W. N. Wei, *Chairman*, Joseph M. Lai and Michael A. Olesnicky, *Members.*

4 December 1985.

Salaries tax—income chargeable under Section 8(1A)(*a*) of the Inland Revenue Ordinance, Cap. 112—Hong Kong Salaries Tax reimbursed by employer—whether subject to apportionment.

The Appellant's liability to Salaries Tax was limited to income derived from services rendered in Hong Kong under Section 8(1A)(*a*). In pursuance of a tax equalization scheme, the Appellant received from the United States based employer an reimbursement of Salaries Tax paid by him in respect of his chargeable income in Hong Kong. The Assessor treated the whole sum as referable to Hong Kong services and not subject to apportionment. The Appellant appealed.

Held:
The reimbursement related solely to the Salaries Tax which in turn related solely to the services rendered in Hong Kong. It was in its entirety income derived from services rendered in Hong Kong.

Appeal dismissed.

Case referred to:—
Vernam v. Deeble (1984) STC 336.

So Chau Chuen for the Commissioner of Inland Revenue.
D. Flux of Peat Marwick, Mitchell & Co. for the Appellant.

Reasons:

1. This case concerns the assessment of Salaries Tax for the year of assessment 1976/77. It is common ground that liability to Salaries Tax is limited to income derived from services rendered in Hong Kong under Section 8(1A)(*a*). The Taxpayer spent 127 days outside Hong Kong in the year in question. The issue in this appeal is whether a sum paid by the employer to the employee in reimbursement of Salaries Tax paid by the employee is or is not wholly income derived from services rendered in Hong Kong.

2. The amount in question, $38,188, is referable to Salaries Tax paid by the employee for certain previous years as well as for 1976/77. It contains a grossed-up equivalent of the Salaries Tax payable by the Taxpayer for 1976/77 to allow for tax on tax so that when the employer reimburses the tax there will be no further assessment.

3. The reimbursement was made by the employer who is based in the U.S.A. in pursuance of a tax equalization scheme.

4. Paragraph 5 of the written submission of Mr. Flux the Taxpayer's representative explains such a scheme. Mr. So for the Commissioner of Inland Revenue accepts the explanation. It is in the following terms:—

> "Tax equalization schemes are adopted by most United States based employers and usually apply to their expatriates working outside of the United States whether in a branch or subsidiary. The intention is to encourage service outside the United States and in any country, whatever the tax impact in that country. The basic remuneration is reduced by "hypothetical tax" which is the amount of tax that the individual would pay if working in the USA in the employer's home state. The employer then reimburses all actual taxes suffered by the employee. Theoretically therefore the employee's net income after taxation is the same whether he is working in the USA, in a tax haven or in a highly taxed country. This agreement is not based on any pre-examination by the employer of what the foreign taxes will be; it is a universal agreement whereby, in some cases the employer gains and, in others, he loses, depending upon where the employees are based."

5. Mr. Flux submits that it is not proper to compartmentalize any individual item in the remuneration package unless the employer has contractually provided that any such item is for identifiable services as opposed to all services, and he relies on the case of Varnam v. Deeble (1984) STC 336. In that case, the taxpayer attempted to allocate a weighted proportion to duties performed outside the United Kingdom on the ground that those duties were more onerous but it was held that his emoluments should be deemed to accrue evenly from day to day because there were no express contractual provisions to the contrary.

6. Mr. Flux concedes that Varnam v. Deeble does not concern a tax refund. The emoluments in question were a fixed salary plus a commission based on the assumed profits of his employer for the accounting period. There was no contractual provision for a weighted apportionment in favour of his service abroad. Indeed, the employer's articles of association provided that his emoluments were deemed to accrue from day to day. In these circumstances it was held that his emoluments, i.e., his salary and commission, should be time apportioned. The question was whether there should be a weighted apportionment, it being assumed or accepted by all parties concerned that the emoluments in question covered all his services wherever performed.

7. In the present case the income in question is a sum paid by the employer by way of reimbursement of Salaries Tax which is referable solely to services rendered in Hong Kong. There can be no doubt that the employer, in paying the sum to the employee, intended it to be a refund of Hong Kong Salaries Tax. It was not income such as salary which by reason of its nature refers, in the absence of express terms to the contrary, to services wherever rendered.

8. The question remains whether in the case of a tax refund there should be time apportionment. Here we take the view that the nature of the payment from the viewpoint of the taxpayer is the material factor. The payment was intended to, and did effectively, take over the Taxpayer's liability to Salaries Tax. In fact that must be so even from the viewpoint of the employer at the time when the payment was made. The payment was received pursuant to a term in the Taxpayer's contract of employment (as implied by the existence of the tax equalization scheme referred to earlier) which provided for reimbursement of any Salaries Tax paid by the Taxpayer. This contractual term therefore provides a link between the payment and the services in Hong Kong, and takes the payment outside the scope of the time apportionment principle as set out in Varnam v. Deeble. By reason of its nature and by virtue of the terms of the Taxpayer's contract of employment, the sum paid, as income under the Hong Kong law, relates solely to the Salaries Tax which in turn relates solely to services rendered in Hong Kong. In our view, the test is whether the whole of the tax refund can be traced to services in Hong Kong as its origin, or alternatively, whether, if no services had been rendered in Hong Kong, the employer would still have paid the sum of the refund or any part thereof. The application of either test points to the same conclusion, namely, that the tax refund in its entirety is income derived from services rendered in Hong Kong.

9. For these reasons, the decision of the Board by a majority of two to one is that the appeal is dismissed and the Commissioner's assessment confirmed.

10. Mr. Joseph Lai the third member of the Board considers that the appeal should be allowed for the following reasons:—

> "Although the Salaries Tax paid in this case was calculated on a "time-in Time-out" basis in order to arrive at the Appellant's income received for Hong Kong services, such tax amount, in the absence of specific contract provision and under a tax equalization scheme, is part of the Appellant's total remuneration package. As such, the tax paid by the employer should be aggregated with the other income of the Appellant, including income taxes paid in other jurisdictions, if any, to arrive at the total income of the Appellant, before determination of the proportion of the Appellant's income relates to Hong Kong services. The fact that no income tax was paid in other jurisdications in this particular instance should have no bearing on the principle of the matter. Thus my decision is for the appeal to be up-held."