INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D35/03

Salaries tax – whether the sum of money is a rental refund or a salary – section 9(1A) of the Inland Revenue Ordinance ('IRO') – whether or not landlord and tenant relationship is crucial in a claim under section 9(1A)(a)(ii) of the IRO – whether or not it is necessary to have a nexus between the payment by the employee and his or her use of the property for which the rent is paid.

Panel: Andrew J Halkyard (chairman), Aarif Tyebjee Barma and Charles Graeme Large.

Date of hearing: 20 May 2003.
Date of decision: 17 June 2003.

The appellant claims that the sum of $450,000 paid to him by his employer Company A is a refund of rent made for the property leased by his family company, Company B. The appellant contends that this sum should not be taxed as either a salary or a cash allowance.

Held:

1. After careful consideration, and having taken into account the various documents that might point to the opposite conclusion that the sum is in the nature of salary, on the balance of probabilities, the appellant has satisfied the Board that the nature of the amount in dispute of $450,000 was intended to be a housing benefit in the form of a rental refund rather than a salary or allowance which the appellant could spend in whatever way he wished.

2. The Board accepted that the appellant did pay for the use of the property. For instance, if the accommodation provided was a hostel or hotel room, and an employee paid for such accommodation, no landlord and tenant relationship would exist. Usually in such a case the employee would occupy the accommodation under the terms of a licence. Yet clearly the intention of the IRO shows that such payments would qualify as 'rent' for the purposes of section 9(1A) and the Commissioner in computing rental value would take into account any refund to the employee by the employer.

3. And what would be the result if the tenant were not Company B but the appellant's wife? Would the Commissioner take the same approach and deny that the appellant had paid rent for the matrimonial home? Neither of these examples nor the present case seems abusive, and the Board doubted whether

any purposive construction of the phrase 'the rent paid by the employee' contained in section 9(1A)(a)(ii) would lead to denying a claim under that provision simply because there is no landlord and tenant relationship between the employee and the owner or lessor of the premises (CIR v Page [2002] HKEC 1399 and D21/98, IRBRD, vol 13, 203 considered).

4. Applying a purposive construction to the phrase 'the rent paid by the employee', it is necessary to have a nexus between the payment by the employee and his or her use of the property for which the rent is paid. The advantageous salaries tax treatment for housing benefits in the IRO cannot apply simply because the employee discharges a rental obligation for which a third party is liable. But in the present case that nexus clearly exists.

5. The Board concluded that this payment represented rent for the use of the property under either a licence or under a sublease, and that this conclusion was not affected by the fact that the terms of the lease between Company B and the landlord prohibited subletting. Whether or not a sublease is authorised by a head lease, the fact remains that the appellant resided in the property at all relevant times and paid consideration for his occupancy. In the Board's view, this payment was in the nature of rent for the purposes of section 9(1A)(ii) and this was refunded by Company A to the extent of $450,000 for the period 1 July 2000 to 31 March 2001 (D149/00, IRBRD, vol 16, 83 considered).

Appeal allowed.

Cases referred to:

CIR v Page [2002] HKEC 1399
D21/98, IRBRD, vol 13, 203
D149/00, IRBRD, vol 16, 83

Leung Wing Chi for the Commissioner of Inland Revenue.
David H Southwood of Messrs Grant Thornton, Certified Public Accountants, for the taxpayer.

Decision:

1. This is an appeal against a salaries tax assessment for the year of assessment 2000/01. The Appellant claims that the sum of $450,000 paid to him by his employer Company A is a refund of rent made for the property leased by his family company, Company B. The Appellant contends that this sum should not be taxed as either a salary or a cash allowance.

2. The facts are agreed. They are stated in the Commissioner's determination dated 15 January 2003, and we so find. These were supplemented by additional documents submitted by both parties and, where relevant to our decision, we refer to these below. At the Board hearing Mr David H Southwood of Messrs Grant Thornton, certified public accountants, represented the Appellant; Ms Leung Wing-chi represented the Commissioner. Neither party called any oral evidence.

3. Our starting point in analysing this dispute is to consider the recent case of CIR v Page [2002] HKEC 1399 where Recorder Edward Chan, SC stated:

> *'7. The crucial question is what is the nature of the payment [in dispute]. This is a question of fact. The starting point is of course the contract between the taxpayer and the employer. If by the terms of the contract, the payment was to be in the nature of rental refund, then plainly due weight must be given to the contractual provisions. However in my view, although the terms of the contract are an important and weighty factor, this is not the sole factor. This is because (a) the parties may by their conducts vary the terms of the contract; or (b) even if the conducts do not amount to a variation of the terms of the contract, the parties' conducts may be such that the payment is not made in strict accordance with the terms of the contract and so the payment may be of a nature different from what is provided for in the contract.'*
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> *'15. It was suggested that in order for a payment to qualify as a rental refund, a taxpayer must be able to show that his employer has a system of control exercised over the payment so as to ensure that the payment was really a refund of the rent paid by the taxpayer and not just an extra allowance paid to the taxpayer. Insofar as it is suggested that as a matter of law, the payment by an employer could never amount to a rental refund unless it is shown that the employer has a system of control in place to verify that the payment is really a refund of rent, I would disagree with such suggestion. I see no reason why the clear wordings of section 9(1A) that "where an employer or an associated corporation (ii) refunds all or part*

of the rent paid by the employee, such payment or refund shall be deemed not to be income" should be qualified by the additional requirement that the employer must have a particular kind of system or arrangement to control over the payment made by the employer, or to verify that the payment made is a refund of rent paid by the employee. If an employee has paid rent and under the contract of employment the employee is entitled to be reimbursed of the amount of rent he paid in whole or in part and the employer does reimburse the employee of the appropriate amount, I cannot see any reason to say that the amount paid by the employer to the employee should not be called a refund of rent in whole or in part simply because the employer has chosen not to ask the employee for any evidence of his payment or simply because the employer has not implemented any system or arrangement to make sure that what he paid is by way of refund of rent. Indeed, such system for verification is merely for his own protection to make sure that he is not being asked to pay more than what he is obliged to under the contract. If under the contract, all that the employer is obliged to do is to refund any rent paid up to a certain amount, the fact that he does not seek verification of the amount he is required to pay under the contract before he pays over the sum does not mean that what he pays is not a refund in discharge of his contractual obligation. Certainly this would not affect the right on the part of the employer to recover any overpayment if subsequently he discovers that he is paying more than he is obliged to. What I am prepared to hold is that as a matter of fact, it would generally be of great assistance to the taxpayer intending to claim the benefit of section 9(1A) to be able to show that his employer does have some sort of system to make sure that the amount paid by the employer to him is in fact in the nature of a refund of the rent paid by him, the taxpayer. In this regard, I accept the view that "refund" means "pay back (money or expenses) or reimburse" (see Board of Review case No. D21/98).'

' 18. On the facts of the present case, the majority of the Board found that the payment [in dispute] by the employer was rent refund. The majority took the view that "the real test was the nature of the payment itself and this in turn depends on the intention of the parties at the time they entered into the contract of employment". 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.'

4. On the facts found, the above quotations go to the heart of this appeal – and on the balance of probabilities the Appellant has satisfied us that the nature of the amount in dispute of $450,000 was intended to be a housing benefit in the form of a rental refund. Specifically, we find that the Appellant did pay rent in an amount of at least $450,000 during the year of assessment 2000/01 and that the payment of $450,000 made by Company A to the Appellant was in the nature of rental refund rather than a salary or allowance which the Appellant could spend in whatever way he wished. Our analysis follows.

Housing benefit or salary?

5. Setting out the relevant facts chronologically is the best approach for this aspect of the appeal.

(a) February to March 2001: Company A issued statements in respect of the Appellant for contributions made to the Mandatory Provident Fund ('the MPF Statements'). These statements showed the following particulars:

Payroll period	**December 2000**	**January 2001**	**February 2001**	**March 2001**
Contribution date	5-2-2001	5-2-2001	5-3-2001	5-4-2001
	$	$	$	$
Relevant income[1]	75,000		75,000	
Basic salary		75,000		75,000
Bonus		75,000		-
Total		150,000		75,000

(b) 2 May 2001: Company B filed with the Inland Revenue Department ('IRD') an employer's return in respect of the Appellant for the year ended 31 March 2001. The Appellant signed this return. It showed that although Company B paid no income to the Appellant, it provided quarters at Address C ('the Property') to the Appellant and stated: 'rent paid by employee to the landlord and wholly reimbursed by the employer'.[2]

[1] It is common ground that section 2(1) of the Mandatory Provident Fund Schemes Ordinance defines 'relevant income' to include items such as salary and bonus, but to exclude a housing allowance or other housing benefit.

[2] From documents submitted to us by both parties, at all relevant times Company B paid the rent for the Property directly to the landlord by issuing cheques to the landlord. The landlord then issued appropriate receipts to Company B. Mr Southwood argued however that with effect from 1 April 2000 the Appellant was responsible for paying the rental and related costs (Government rates and management fees), and that the relevant amounts were debited to the Appellant's current account with Company B. For this purpose, Mr Southwood referred to the income statement of Company B for the year ended 31 May 2001 (these amounts were *not* recorded therein) and produced a summary of the current account showing the amounts debited. Ms Leung did not dispute the actual payments made by Company B. But without sighting the accounting ledgers she did not agree that the Appellant paid any amount as rent. She would only go so far as to agree that the Appellant, who with his wife

(c) 31 May 2001: Company A filed with the IRD an employer's return in respect of the Appellant for the year ended 31 March 2001. It was signed by Company A's director of finance and showed that Company A paid the Appellant 'salary/wages' of $750,000 and 'bonus' of $374,957 (total $1,124,957).

(d) 17 September 2001: Company A filed with the IRD an amended employer's return in respect of the Appellant for the year ended 31 March 2001. Company A's director of finance also signed it. It showed that Company A paid the Appellant 'salary/wages' of $300,000 and 'bonus' of $374,957 (total $674,957). It also stated that for the period 1 July 2000 to 31 March 2001 Company A provided the Property to the Appellant as quarters and stated: 'rent paid to landlord by employee $451,125' and 'rent refunded to employee $450,000'.

(e) 8 October 2001: the Appellant filed with the IRD his tax return for the year of assessment 2000/01 disclosing that he received income from Company A as director in the amount of $674,957. In this return, he also disclosed that for the period 1 July 2000 to 31 March 2001 Company A provided the Property to him as quarters and stated: 'rent paid by me to landlord $451,125' and 'rent refunded to me by employer $450,000'.

(f) 5 December 2001: in response to an enquiry from the assessor, Company B stated: 'Before replying to your detailed questions we would point out that in the year ended 31 March 2001 [the Appellant] was not in receipt of any income from [Company B] in the form of salaries or housing benefits. We believe the confusion may have arisen due to a clerical error in completing [the employer's return for the Appellant] for the year ended 31 March 2001. This return should have been completed on a Nil basis and in fact the return was completed showing that [the Appellant] has no income from the company in the year ended 31 March 2001. However due to a clerical error, Part 12 of the return [which concerned particulars of quarters provided] was completed in the same manner as in previous years whereas in fact the company did not pay any housing benefits for him in the period.'

(g) 5 December 2001: in response to an enquiry from the assessor, Company A made certain assertions. This is an important document and we will quote it virtually in full:

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were the sole beneficial owners of Company B, funded the payment of the rent (and related costs) by Company B.

'There is no formal employment contract between [Company A] and [the Appellant]. The terms of [the Appellant's] employment with effect from 1 July 1999 were that he would be remunerated with a monthly salary of $25,000 per month. The initial arrangement was for a period of one year during which both parties would evaluate the working relationship.

At the successful completion of the first year [the Appellant's] remuneration package was increased to $75,000 a month from 1 July 2000 which comprise:

	HK$
Salary	25,000
Housing benefit	50,000
	75,000

[The Appellant's] monthly housing cost was in excess of $50,000 and we have sighted both his tenancy agreement and receipts for the various expenditure on his rental and rates.

Housing benefits are provided to the employee on a selected basis. Where housing benefits are provided to eligible employees the following rules are followed.

The housing benefit provided by [Company A] must be equal to or less than the actual cost incurred by the employee.

[Company A] will either reimburse the employee for housing costs paid to the landlord by the employee or pay the rent directly to the landlord. In the former case the employee is required to produce evidence of the lease in the form of the tenancy agreement and to produce documentary evidence of the payments for which reimbursement is made.

Please see above in [the Appellant's] case the housing benefit represented a reimbursement of cost borne by [the Appellant] and we have had sight of his tenancy agreement and other supporting documentation to evidence that the reimbursement was less than the housing cost incurred by [the Appellant] in the period 1 July 2000 to 31 March 2001.

As set out above [the Appellant] was entitled to a housing reimbursement in the period 1 July 2000 to 31 March 2001 we attach herewith a copy of the tenancy agreement and rental invoices covering the period. You will note that the lease is in the name of [Company B] as tenant. However with effect from

> 1 April 2000 [the Appellant] has borne the cost of housing himself and with effect from 1 July 2000, we have reimbursed [the Appellant] for part of these costs.'

6. It is obvious that there are discrepancies in the documents extracted above. However, on the balance of probabilities we find that the nature of the sum in dispute ($450,000) was intended as a housing benefit in the form of a rental refund. We have arrived at this conclusion after careful consideration, and having taken into account the various documents that might point to the opposite conclusion that the sum is in the nature of salary. These documents were the MPF Statements (paragraph 5(a) above)[3], the reference therein to a 'bonus' of $75,000 (an amount exactly equal to the amount described as 'basic salary'), Company B's employer's return (paragraph 5(b) above), and Company A's original employer's return (paragraph 5(c) above).

7. During the hearing we asked Mr Southwood what he relied upon to show that the 'labelling' in the MPF Statements was wrong. He replied that he relied upon Company A's letter dated 5 December 2001 (paragraph 5(g) above). To this, we would add the amended employer's return (paragraph 5(d) above), the Appellant's tax return (paragraph 5(e) above) and, tangentially, the income statement of Company B for the year ended 31 May 2001 (which, in contrast to the previous year, did not contain any amount for rent paid for the Property). We find from these various documents that the monthly increase in the Appellant's remuneration commencing 1 July 2000 ($50,000) did take into account the economic cost to the Appellant of the rent for the Property (which was slightly over $50,000). Moreover, Company A's letter of 5 December 2001 is clear evidence that with effect from 1 July 2000 it had agreed with the Appellant to vary the terms of his contract of employment to provide a monthly housing benefit of $50,000. This finding is bolstered by Company A's statement in that letter that it had sighted a copy of the lease for the Property and was satisfied that the Appellant had incurred housing costs in respect of the Property for the period 1 July 2000 to 31 March 2001. In this regard, we reiterate the decision of Edward Chan, SC in Page's case who stated at paragraph 15: *'What I am prepared to hold is that as a matter of fact, it would generally be of great assistance to the taxpayer intending to claim the benefit of section 9(1A) to be able to show that his employer does have some sort of system to make sure that the amount paid by the employer to him is in fact in the nature of a refund of the rent paid by him, the taxpayer.'* In passing, we note that Company A is associated with but *not* controlled by the Appellant.

8. In the event, notwithstanding Ms Leung's best endeavours, it is our view that the probative value of the documents she relied upon is outweighed by those matters referred to above. Applying Page's case, we find on the balance of probabilities that with effect from 1 July 2000 the parties agreed to provide the Appellant with a housing benefit of $50,000 per month in the nature of

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[3] In this regard we note that the statutory limit for MPF Scheme monthly contributions by both employer and employee is 5% of $20,000, namely $1,000. To this limited extent, it would not matter if the 'salary' in the MPF Statements was recorded as $25,000 or $75,000, since the level of the mandatory contributions would be the same.

a rental refund, as distinct from salary or allowance. And, unlike Page's case, the subsequent conduct of the parties did not vary the terms of this agreement; nor did the payments subsequently take on a different nature from that agreed by the parties. It follows that if the amount in dispute was truly a refund of rent, then the Appellant succeeds in his appeal.

Has Company A refunded ' rent paid by the employee' for the purposes of section 9(1A)?

9. Essentially, Ms Leung argued that the sum in dispute could not be a refund of 'rent' within section 9(1A) because there was no legally binding landlord and tenant relationship between the Appellant and the owner of the Property. Although Ms Leung was prepared to accept (see note 2 above) that the Appellant funded the rent and related payments through Company B to the owner, she was not prepared to accept that the Appellant actually made any payments of rent. In this regard, Ms Leung argued that strictly a rent is a periodical payment reserved as such in a lease and payable by the tenant to the landlord. For his part, Mr Southwood argued that it was not necessary for the purposes of applying section 9(1A) for a landlord and tenant relationship to exist between the Appellant and the owner of the Property. Instead, it was sufficient if the Appellant paid consideration for the use of the Property.

10. On the basis of the facts found, we are inclined to accept Mr Southwood's argument that the Appellant did pay for the use of the Property and we conclude that Ms Leung's submissions placed too restrictive an interpretation of the concept of rent (when she insisted that a landlord and tenant relationship must exist between the Appellant and the owner of the Property). For instance, if the accommodation provided was a hostel or hotel room, and an employee paid for such accommodation, no landlord and tenant relationship would exist. Usually in such a case the employee would occupy the accommodation under the terms of a licence. Yet clearly the intention of the IRO shows that such payments would qualify as 'rent' for the purposes of section 9(1A) and the Commissioner in computing rental value would take into account any refund to the employee by the employer. And what would be the result if the tenant were not Company B but the Appellant's wife? Would the Commissioner take the same approach and deny that the Appellant had paid rent for the matrimonial home? Neither of these examples nor the present case seems abusive, and we doubt whether any purposive construction of the phrase 'the rent paid by the employee' contained in section 9(1A)(a)(ii) would lead to denying a claim under that provision simply because there is no landlord and tenant relationship between the employee and the owner or lessor of the premises.

11. We should add, however, that applying a purposive construction to the phrase 'the rent paid by the employee',[4] it is necessary to have a nexus between the payment by the employee and his or her use of the property for which the rent is paid. To this extent we agree with Ms Leung

[4] We note that both parties referred to the history of enactment and amendment to section 9(1A), originally inserted by the Inland Revenue (Amendment) Ordinance 1954. The object of the Bill, as set out in the Explanatory Memorandum, was to exclude from the definition of the word 'income' the refunds paid to an employee by the employer in respect of the rent paid by the employee. The effect of the subsection was said to place such an employee on equal footing with one provided by the employer with a place of residence, either rent free or for a nominal rent.

that the advantageous salaries tax treatment for housing benefits in the IRO cannot apply simply because the employee discharges a rental obligation for which a third party is liable. But in the present case that nexus clearly exists.

12. In the event, we do not have to decide this issue on the basis of the competing arguments of both parties, since we have taken a different view of the facts from that advanced by the Appellant and countered by Ms Leung in her submissions at note 2 above.

13. In his submission, Mr Southwood appeared to argue that Company B was simply a conduit for payment of the rent since the Appellant was 'responsible' for paying the rent to the owner of the Property with effect from 1 April 2000. We find that Company B was liable to pay rent to the landlord, it did pay rent to the landlord, and in accordance with the terms of the lease which restricted residence to the Appellant, his family and servants only, it allowed the Appellant and his family to reside in the Property. No novation of the lease took place and the Appellant was not responsible to the owner of the Property to pay the rent. However, on the basis of the income statement and the Appellant's current account balances with Company B shown in its accounts for the years ended 31 May 2000 and 2001 (and having also considered the summary of the current account provided by Mr Southwood), we find that the total cost of the rent and the related expenses for the Property during the relevant period were debited to the Appellant as a result of his occupying the Property, and that this constitutes payment by him to Company B (see D149/00, IRBRD, vol 16, 83).[5]

14. We conclude that this payment represents rent for the use of the Property under either a licence or under a sublease, and that this conclusion is not affected by the fact that the terms of the lease between Company B and the landlord prohibited subletting. Whether or not a sublease is authorised by a head lease, the fact remains that the Appellant resided in the Property at all relevant times and paid consideration for his occupancy. In our view, this payment is in the nature of rent for the purposes of section 9(1A)(ii) and, as indicated above, this was refunded by Company A to the extent of $450,000 for the period 1 July 2000 to 31 March 2001.

Conclusion

15. In accordance with the above analysis, we conclude that (1) the Appellant paid rent for the use of the Property, and (2) the amount in dispute of $450,000 was intended to be, and was paid as, a housing benefit that can be classified as a refund of rent paid by the Appellant within the terms of section 9(1A)(ii). The appeal is hereby allowed.

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[5] In this case the Board stated: *'At all relevant times, the current account of the Taxpayer with [his family company or landlord of the premises] was in credit… We know of no authority, and none was submitted to us, that states that a payment of rent must be a direct physical act and cannot be satisfied by way of offsetting moneys owed by the lessor to the lessee.'*

16. Before concluding, we thank both Ms Leung and Mr Southwood for the considerable assistance with which they have provided us during this appeal.