Case No. D37/03

Salaries tax – taxability of income arising from employment with constituent members of multi-national groups of companies – section 8(1) and 8(1A) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Malcolm John Merry and Mary Teresa Wong Tak Lan.

Dates of hearing: 22 February and 18 March 2003.
Date of decision: 8 July 2003.

By an agreement made between the appellant, Company A-International (a corporation organized under the laws of the Netherlands) and Company C, the appellant sold his remaining 75% interest in Company C to Company A-International. The share sale agreement provided that the appellant shall deliver to Company A-International an employment agreement between the appellant and Company C in form as set forth in an attachment to that agreement.

By an employment agreement dated 1 August 1999 ('the First Employment Letter') the appellant was offered employment at the level of managing director at Company B-Hong Kong. The First Employment Letter provided that '[Company B-Hong Kong] shall employ [the appellant] on a full-time basis, as Managing Director, Asia/Pacific' and '[the appellant] will be based in Hong Kong'.

By letter dated 15 August 1999 ('the Second Employment Letter') Mr E purported to confirm the parties' agreement 'regarding our offer of employment at the level of Managing Director, Asia Pacific to be based in Hong Kong'. The Second Employment Letter was submitted by the director-human resources of Asia Pacific to the Hong Kong Immigration Department in support of the appellant's application for a Hong Kong employment visa. Company B-Asia acted as the appellant's sponsor in that application.

By letter dated 4 October 1999 ('the Third Employment Letter') signed by Ms G for '[Company A], acting through its division [Company B]' the appellant was offered the position of 'President and Chief Executive Officer of our Asia Pacific Region'.

By an employer's return dated 15 May 2000, Company B-Asia reported to the Revenue the income of the appellant for the period between 1 September 1999 and 31 March 2000. In the 'Remarks' section of this return, Company B-Asia pointed out that 'The staff should be entitled to

time apportionment'. A like claim was made by the appellant in his return dated 21 July 2000. The appellant accepted in that return that Company B-Asia was his employer and he sought 'Partial' as opposed to 'Full' exemption of his income on the basis that he was 'not in Hong Kong for many days'.

The appellant told the Board that it was agreed during the negotiations of the share sale agreement that he will sign standard employment agreements to be prepared by Mr K, then legal counsel of Company A. According to the appellant, the Second Employment Letter was 'a preliminary offer letter' prepared in support of his visa application. It was superseded by the First Employment Letter. Company B-Asia was merely representing his foreign employer Company A in connection with his visa renewal application. The appellant explained that the name Company B-Hong Kong was inserted into the First Employment Letter by mistake.

Held:

1. The Board finds it difficult to accept the appellant's case that a mistake was made in the First Employment Letter. It was drafted by Mr K. As legal counsel of Company A, one would expect him to state expressly that Company A was the appellant's employer had that been the case. The First Employment Agreement must also be viewed in the context of the share sale agreement. A company incorporated in the Netherlands was nominated as the purchaser under that agreement. The identity of the contracting party was a matter handled with care.

2. There was no evidence indicating payment by Company A of the salary stipulated in the Third Employment Letter. Nor was there evidence of reimbursement by Company A to Company B-Asia on the appellant's salary payments.

3. By their returns both Company B-Asia and the appellant admitted the subsistence of an employment relationship between them. The appellant had not proffered any satisfactory explanation for such admissions.

4. The Board is of the view that the totality of the evidence before the Board indicates that the appellant was not an employee of Company A but an employee of its Hong Kong affiliates. The Board is of the view and it so finds that the appellant's income arose in or was derived from Hong Kong from his office of employment with Company B-Asia.

Appeal dismissed.

Cases referred to:

CIR v Goepfert 2 HKTC 210
D17/90, IRBRD, vol 5, 143
D40/90, IRBRD, vol 5, 306

Fung Ka Leung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. Company A is a publicly quoted company incorporated under the laws of the state of Delaware. Its carries on an international communications and perception management business through numerous subsidiaries whose names include the word '[Company B]'. The Appellant first joined the group in 1982, working in London and the Middle East. He was assigned to Korea in 1986 to manage the public relations programme for the 1988 Seoul Olympics.

2. In 1989, the Appellant established Company C in Korea. It was Korea's first international public relations consulting firm.

3. Company B-International was one of the wholly owned subsidiaries of Company A. In 1996, Company B-International acquired a 25% interest in Company C. The Appellant and Mr D retained the remaining 75% interest in that company.

4. By an agreement dated 1 August 1999 ('the Share Sale Agreement') and made between the Appellant, Company A-International (a corporation organized under the laws of the Netherlands) and Company C, the Appellant sold his remaining 75% interest in Company C to Company A-International. Clause 3.2(b) of the Share Sale Agreement provided that at closing scheduled on 3 September 1999, the Appellant shall deliver to Company A-International an employment agreement between the Appellant and Company C in form as set forth in attachment B to that agreement. Attachment B has not been placed before us and we are not aware of its precise terms.

5. By an employment agreement also dated 1 August 1999 ('the First Employment Letter'), the Appellant was offered employment at the level of managing director at Company B-Hong Kong. The name B and an address in New York can be found on the first page of the First Employment Letter. The First Employment Letter was signed by Mr E with the title of 'CEO-Asia/Pacific'; Mr F with the title of 'Chief Financial Officer' and Ms G with the title of

'Managing Director Human Resources Worldwide'. The three of them appended their signatures under the name of Company B-Hong Kong. The First Employment Letter provided as follows:

(a) By clause 1: 'Effective September 1, [Company B-Hong Kong] shall employ [the Appellant] on a full-time basis, as Managing Director, Asia/Pacific ...'.

(b) By clause 2: 'You will be based in Hong Kong and will report to [Mr E]'.

(c) By clause 3: 'Your annual base salary from the date you commence employment will be HK$1,560,000'. This gives a figure of $130,000 per month.

(d) By clause 4: 'You shall be entitled to participate in the various benefits plans available to senior employees of [Company B-Hong Kong]'.

(e) By clause 5: '[Company B-Hong Kong] will provide you with housing, tuition and other employee and expatriate benefits not to exceed HK$1,365,000 annually'.

(f) By clause 9b): 'During the term of your employment and for a period of two years thereafter, you shall not perform in Hong Kong, China, Japan or Korea any services for ... any person, firm or entity which is a competitor of [Company B-Hong Kong] or [Company A], or affiliated Companies ...'.

(g) By clause 11: 'Any controversy or claim arising out of or relating to this Agreement ... shall be conclusively settled by arbitration to be held in New York, NY, in accordance with the American Arbitration Association's Employment Dispute Resolution Rules'.

(h) By clause 16: 'This agreement shall be governed by, and construed in accordance with the laws of New York ...'.

6. By letter dated 15 August 1999 signed by Mr E and sent to the Appellant in New Zealand ('the Second Employment Letter'), Mr E purported to confirm the parties' agreement 'regarding our offer of employment at the level of Managing Director, Asia Pacific to be based in Hong Kong'. The Second Employment Letter was written on paper bearing the name B but giving an address in Hong Kong. According to the Second Employment Letter, the Appellant's employment was to start on 1 September 1999 'with the understanding that you will report to work once you have obtained Hong Kong employment visa through the Company's sponsorship'. The Appellant's 'base salary will be HK$1,440,000 per annum, paid in twelve equal monthly instalments' amounting to $120,000 per month. The Second Employment Letter was submitted by Ms H, director-human resources, Asia Pacific to the Hong Kong Immigration Department in

support of the Appellant's application for a Hong Kong employment visa. Company B-Asia acted as the Appellant's sponsor in that application.

7. By letter dated 4 October 1999 ('the Third Employment Letter') signed by Ms G for '[Company A], acting through its division [Company B]', the Appellant was offered the position of 'President and Chief Executive Officer of our Asia Pacific Region, effective November 4, 1999'. The Third Employment Letter provided that:

(a) 'The purpose of this letter is to set out the terms and conditions of your continued employment with [Company A]'.

(b) 'You will report to [Mr I], President and Chief Executive Officer, Worldwide, and will sit on [Company B's] Executive Board'.

(c) 'Your base salary will be at the annual rate of $250,000'.

(d) 'In addition to your base salary, you will be eligible to participate in the 2000 Key Corporate Managers Bonus Program (KCMBP)'.

(e) 'The Company will continue to provide you with other housing, tuition, and other employee and expatriate benefits not to exceed $175,000 annually'.

This appointment of the Appellant was confirmed by a letter from Mr I to the Appellant dated 1 November 1999 and announced in Hong Kong by a press release dated 4 November 1999. The Appellant's responsibilities remained the same after this appointment. He led and managed all Company B's operations in the Asia Pacific region.

8. By a memorandum dated 18 October 1999, Ms J wrote to the Appellant using the letterhead of Company A. The Appellant was advised on the manner whereby claims may be lodged under an international health plan applicable to him.

9. With effect from 15 November 1999, the Appellant was appointed a director of Company B-Asia. Mr E resigned as director of that company on the same day. According to the report of Company B-Asia's directors for the year ended 31 December 1999, the principal activities of that company 'are investment holding and the provision of public relations services'. Company A was described as its 'previous ultimate holding company' whilst Company B-Hong Kong was listed as one of its wholly owned subsidiaries.

10. By a stock option agreement dated 25 April 2000, Company A granted in favour of the Appellant an option with respect to 6,180 common stock of Company A on the basis of an incentive compensation plan designed to encourage officers and employees of Company A 'and its

Affiliates' to continue with these entities. By letter dated 5 May 2000, Company A informed the Appellant that he had been selected to participate in the 2000 KCMBP.

11. By an employer's return dated 15 May 2000, Company B-Asia reported to the Revenue the income of the Appellant for the period between 1 September 1999 and 31 March 2000 at $1,096,796. This sum included salary ($1,002,500), education benefits ($64,565), other benefits in kind ($22,807) and living allowance ($6,924). In relation to the salary component, the Appellant was paid $120,000 per month for the months of September and October 1999 and $152,500 for each of the months between November 1999 and March 2000. In the 'Remarks' section of this return, Company B-Asia pointed out that 'The staff should be entitled to time apportionment'. A like claim was made by the Appellant in his return dated 12 July 2000. The Appellant accepted in that return that Company B-Asia was his employer and he sought 'Partial' as opposed to 'Full' exemption of his income on the basis that he was 'not in Hong Kong for many days'. During the period between 1 September 1999 and 31 March 2000, he made frequent trips abroad for business and other purposes. He was away from Hong Kong for a total of 87 days.

12. The monthly salary of the Appellant referred to in paragraph 11 above was paid by Company B-Asia in Hong Kong through direct debit on the 26th of each month to a bank account in Hong Kong. For the year ended 31 December 1999, 20% of such salary was borne by Company B-Asia and 80% was borne by operating companies in Japan, Korea, China, Hong Kong, Singapore and Australia. For the year ended 31 December 2000, 23% of his emoluments was borne by Company B-Asia and 77% by the other operating companies.

13. On 11 September 2000, Company B-Asia applied to the Immigration Department for extension of the Appellant's employment visa. Company B-Asia informed the Immigration Department that the Appellant 'is still under the employment of our Company as Chief Executive Officer, Asia Pacific ...'.

The issue

14. We are concerned with the Appellant's liability for salaries tax for the year of assessment 1999/2000. The Revenue contends that the Appellant is liable for salaries tax under section 8(1)(a) of the IRO on the basis that either Company B-Hong Kong (under the First Employment Letter) or Company B-Asia (under the Second Employment Letter) was the Appellant's employer and the sum of $1,096,796 was income arising in or derived from Hong Kong from such employment of profit.

15. The Appellant contends that his position is within section 8(1A)(a) of the IRO. He maintains that Company A was his employer under the First and the Third Employment Letters and he is therefore chargeable merely for income from services which he rendered in Hong Kong.

Evidence adduced by the Appellant

16. The Appellant told us that he commenced negotiations in early July 1999 with Mr F. According to a memorandum from Mr F dated 3 August 1999, the parties reached 'Tentative Agreement' in relation to the sale of the remaining 75% interest in Company C. The memorandum further pointed out that the Appellant and Mr D 'will become Managing Directors of [Company B] and will sign standard employment agreements' to be prepared by Mr K, then legal counsel of Company A. This tentative agreement between the parties was struck when Mr F was in New York and the Appellant was in Seoul. According to the statement of Mr K dated 24 January 2003, this acquisition was motivated by a desire on the part of Company A to have the Appellant assuming a larger regional management role for Company A's public relations business.

17. According to the Appellant, the Second Employment Letter was 'a preliminary offer letter' prepared in support of his visa application. It was superseded by the First Employment Letter which he signed in Seoul on 2 September 1999. Company B-Asia was merely representing his foreign employer Company A in connection with his visa renewal application.

18. Mr K stated that he circulated various documents for the parties' signature on 27 August 1999. Mr K said he 'was not involved in the details of which entity would, as an administrative matter, issue payroll checks to [the Appellant]'.

19. The Appellant explained that the name Company B-Hong Kong was inserted into the First Employment Letter by mistake. He asserted that the First Employment Letter was in fact concluded with Company A. Mr E, Mr F and Ms G all had the authority to sign on behalf of Company A. Ms G confirmed these assertions in her statement dated 25 February 2003. Ms G further stated that the Appellant 'was hired in 1999 by the [Company B] division of [Company A]'. By letter dated 5 February 2003, a firm of New York lawyers confirmed that Company B, as an unincorporated division of Company A, is capable of entering into a legally binding employment agreement on behalf of Company A.

20. The Appellant further submitted that he did not report to anyone at Company B-Hong Kong. It was never intended that he should work exclusively for the business of Company B-Hong Kong.

The legal principles

21. In CIR v Goepfert 2 HKTC 210 Macdougall J (as he then was):

(a) summarised (at page 238) the operation of section 8(1) of the IRO in these terms:

'If during a year of assessment a person's income falls within the basic charge to salaries tax under section 8(1), his entire salary is subject to

salaries tax wherever his services may have been rendered, subject only to the so called "60 days rule" that operates when the taxpayer can claim relief by way of exemption under section 8(1A)(b) as read with section 8(1B). Thus, once income is caught by section 8(1) there is no provision for apportionment ... On the other hand, if a person, whose income does not fall within the basic charge to salaries tax under section 8(1), derives income from employment in respect of which he rendered services in Hong Kong, only that income derived from the services he actually rendered in Hong Kong is chargeable to salaries tax. ...'

(b) outlined (at page 237) the correct approach to the enquiry as follows:

'*Specifically, it is necessary to look for the place where the income really comes to the employee, that is to say, where the source of income, the employment, is located. As Sir Wilfrid Greene said, regard must first be had to the contract of employment. This does not mean that the Commissioner may not look behind the appearances to discover the reality. The Commissioner is not bound to accept as conclusive, any claim made by an employee in this connexion. He is entitled to scrutinise all evidence, documentary or otherwise, that is relevant to this matter.'*

'There can be no doubt therefore that in deciding the crucial issue, the Commissioner may need to look further than the external or superficial features of the employment. Appearances may be deceptive. He may need to examine other factors that point to the real locus of the source of income, the employment. It occurs to me that sometimes when reference is made to the so called "totality of facts" test it may be that what is meant is this very process'.

22. In relation to the taxability of income arising from employment with constituent members of multi-national groups of companies, the Revenue drew our attention to two decisions of this Board when the issue was considered.

(a) In D17/90, IRBRD, vol 5, 143 the Board at page 145 stated that:

'*The undisputed fact is that the Taxpayer signed a written contract of employment with X Limited, a Hong Kong based company; the contract was signed by both employer and employee in Hong Kong; the salary expressed in Hong Kong dollars was paid by X Limited to the Taxpayer in Hong Kong. Based upon these facts, it seems clear that the income from the Taxpayer's employment, in terms of section 8(1) of the Inland Revenue Ordinance "arose in" or "was derived from" Hong Kong. The*

Taxpayer argued that although the payment of salary and expenses was effected by X Limited, this was merely a matter of "internal billing" and that ultimately the salary and expense were charged to Y Limited in the USA. Assuming that to have been the case (and there was no evidence of the internal bookkeeping put before us) it does not detract from the fact that legal liability for such payments fell on X Limited, and on X Limited alone. Some of the other fringe benefits of the Taxpayer's employment were computed by reference to the Y Group, but ultimate legal liability for such benefits also fell upon X Limited, the Hong Kong company. In these circumstances, it is difficult to give much weight to the "inter-company billings" as between X Limited and Y Limited regarding the Taxpayer's salary and expenses'.

(b) In D40/90, IRBRD, vol 5, 306 the Board at page 315 explained that:

'*We accept the submission by the Taxpayer that his terms of employment and the manner in which he performed his services were substantially different from other employees of the employer in Hong Kong. We accept that he was required to travel extensively outside of Hong Kong and perform services outside of Hong Kong. We likewise accept that for operational purposes the Taxpayer reported to senior staff in USA in the course of performing his services as internal auditor. However, none of the foregoing affects the real source of his income or the place of his employment. In so far as he was performing services overseas, we are to disregard such facts (the Goepfert decision). To whom he reported within the multi-national group of companies does not affect the nature or place of his employment. He was as a matter of fact employed by a company in Hong Kong. If those to whom he reported in practice wished to terminate his services, they could only do so through his employer in Hong Kong'.*

Our decision

23. We find it difficult to accept the Appellant's case that a mistake was made in the First Employment Letter. It was drafted by Mr K. As legal counsel of Company A, one would expect him to state expressly that Company A was the Appellant's employer had that been the case. Instead, the First Employment Letter drew a sharp distinction between Company B-Hong Kong and Company A. Clause 9b) of that letter is wholly inconsistent with the Appellant's contention. The statement of Mr K lends no weight to the view that a mistake was made. The First Employment Letter must also be viewed in the context of the Share Sale Agreement. A company incorporated in the Netherlands was nominated as the purchaser under that agreement. The identity of the contracting party was a matter handled with care.

24. The strength of the Appellant's case rests with the Third Employment Letter. In considering the weight to be attached to that letter, the directive of Macdougall J cited in paragraph 21(b) above is of assistance. The contents of that letter must be tested by reference to objective facts. Had Company A been the true employer of the Appellant, one would expect some evidence indicating payment by Company A of the salary stipulated in that employment letter. There is no such evidence. The Appellant's salary was paid by Company B-Asia and deducted in computing Company B-Asia's profits tax liability. Had such payment been made by Company B-Asia on behalf of Company A, one would expect some evidence of reimbursement. There is also no such evidence. The Appellant relied on the stock option granted to him by Company A. Given the fact that the incentive compensation plan was for the benefit of employees of both Company A 'and its Affiliates', we are of the view that this factor is of limited assistance to the Appellant. D40/90 provides the answer to the Appellant's submission that he did not report to anyone at Company B-Hong Kong.

25. By their returns dated 15 May 2000 and 12 July 2000, both Company B-Asia and the Appellant admitted the subsistence of an employment relationship between them. The Appellant had not proffered any satisfactory explanation for such admissions. We see no reason why the Appellant should not be held to such admissions. We are of the view that the totality of the evidence before us indicates that the Appellant was not an employee of Company A but an employee of its Hong Kong affiliates. Given the fact that the Appellant was paid by Company B-Asia (a Hong Kong company) in Hong Kong, we are of the view and we so find that the Appellant's income arose in or was derived from Hong Kong from his office of employment with Company B-Asia.

26. For these reasons, we dismiss the Appellant's appeal.