

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D38/04

**Salaries tax** – tenancy agreement between employer and employee – sections 8, 9(1), 9(2), 61 and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Patrick Fung Pak Tung SC (chairman), Henry Lau King Chiu and Paul Shieh Wing Tai SC.

Date of hearing: 4 May 2004.

Date of decision: 3 September 2004.

The taxpayer received rental payments from his employer, Company A. The assessor considered that the rental payments were cash allowances and raised additional salaries tax on the taxpayer. The taxpayer objected and claimed that 'the fact that I rented the property to Company A is a legal one. The tenancy is supported by a duly stamped tenancy agreement and relevant rental receipts'. The taxpayer contended that the arrangement was at arm's length. The taxpayer further contended that 'the Revenue in principle accepts such arm's length arrangement and requires the drawing of a tenancy agreement ... The additional assessment in question are contradicting the established principle of IRD'.

#### **Held:**

1. The labelling of a payment by an employer to an employee is not conclusive. It is always a question of fact as to what the true nature of the payment is. It is the substance rather than the form which is determinative. The Board notes that it was not provided in the employment contracts between Company A and the taxpayer that the latter was entitled to any housing benefit or provision of free staff quarters; the rental paid by Company A to the taxpayer together with his 'salary' would always be equivalent to the pre-determined amount of the remuneration payable by Company A to the taxpayer under the employment contracts. The Board is of the opinion that the landlord and tenant relationship between the taxpayer and Company A was 'fictitious' or at least 'artificial' within the meaning of section 61 of the IRO.
2. The Board takes the view that the words – 'if the arrangement is genuine and arm's length and reasonable one, it will not be challenged' – in the Assessment Policy described by the taxpayer in his grounds of appeal in fact are of great assistance to the Commissioner as opposed to the taxpayer.

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### **Appeal dismissed.**

Cases referred to:

D8/82, IRBRD, vol 2, 8

CIR v Peter Leslie Page (HCIA 2/2002 Judgment of Mr Recorder Edward Chan SC delivered on 14 November 2002)

D77/99, IRBRD, vol 14, 528

D93/01, IRBRD, vol 16, 784

D105/00, IRBRD, vol 15, 897

Tse Yuk Yip for the Commissioner of Inland Revenue.

Taxpayer in person.

### **Decision:**

1. This is an appeal by the Appellant ('the Taxpayer') against the determination of the Respondent ('the Commissioner') dated 21 January 2004 ('the Determination') whereby the Commissioner acting by one of her deputies rejected the objection by the Taxpayer to additional salaries tax assessments for the years of assessment 1996/97 to 1998/99 raised on him.

2. By the Determination, the Commissioner confirmed the following assessments for additional salaries tax raised on the Taxpayer:

(i) 1996/97 \$16,784

(ii) 1997/98 \$16,821

(iii) 1998/99 \$16,389

### **The facts**

3. There is practically no dispute on the relevant facts which can be extracted from the Determination as follows:

(i) The Taxpayer has objected to the additional salaries tax assessments for the years of assessment 1996/97 to 1998/99 raised on him. The Taxpayer claims that certain amounts received from his employer should not be chargeable to salaries tax.

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- (ii) (a) By an employment agreement dated 19 September 1994, Company A, now known as Company B, appointed the Taxpayer as an institutional sales in asian equities department commencing on 24 October 1994.
- (b) The Taxpayer's basic monthly salary had been increased to \$45,000 and \$54,000 with effect from 1 April 1996 and 1 April 1997 respectively.
- (c) The Taxpayer ceased employment with Company A on 8 August 1997.
- (iii) The Taxpayer derived a total employment income of \$737,419 from Company C during the period from 1 August 1997 to 31 March 1998.
- (iv) By an employment agreement dated 27 May 1998 Company A appointed the Taxpayer as vice president – asian equities department with effect from 1 June 1998. The conditions of employment included the following terms:

‘ 1) Salary

Your starting basic salary will be HK\$66,000 per month to be restructured later...

...

7) Other staff benefits

You are entitled to other staff benefits including Medical Insurance, Life Insurance and the Provident Fund....’

- (v) Company A filed employer's return for the year ended 31 March 1997 and two notifications under section 52(5) of the Inland Revenue Ordinance ('IRO') in respect of the Taxpayer showing, inter alia, the following particulars:

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
(a) Period of employment	1-4-1996– 31-3-1997	1-4-1997– 7-8-1997	1-6-1998– 27-11-1998
(b) Capacity employed	AVP-Asian Equities	AVP-Asian Equities	VP-Asian Equities
(c) Date of cessation of employment	N.A.	8-8-1997	28-11-1998
(d) Income Salary	\$398,377	\$125,473	\$307,516

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	3,333	12,600	22,000
Leave pay			
Bonus	<u>100,000</u>	<u>45,000</u>	<u>-</u>
Total	<u><u>\$501,710</u></u>	<u><u>\$183,073</u></u>	<u><u>\$329,516</u></u>
 (e) Particulars of quarters provided			
	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
Address :	Address D	The Property	The Property
	(“The Property”)		
Period provided :	(i) 1-4-1996– 30-6-1996	1-4-1997– 7-8-1997	1-7-1998– 27-11-1998
	(ii) 1-11-1996– 31-3-1997		
Rent paid to landlord by the Taxpayer :	(i) \$81,000		
Rent refunded to the Taxpayer :	(i) \$81,000		
Rent paid to landlord by the employer :	(ii) \$120,000	\$142,903	\$129,360

(vi) In his tax returns for the years of assessment 1996/97 to 1997/98, the Taxpayer declared the same income from Company A as per sub-paragraph (v) above and the following particulars of quarters provided to him:

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
Address :	The Property	The Property	The Property
Period provided :	(i) 1-4-1996– 3-6-1996	1-4-1997– 7-8-1997	1-7-1998– 27-11-1998
	(ii) 1-11-1996– 31-3-1997		
Rent paid to landlord by the Taxpayer :	(i) \$81,000		
Rent refunded to the Taxpayer by Company A :	(i) \$81,000		
Rent paid to landlord by Company A :	(ii) \$120,000	\$142,903	\$129,360

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- (vii) The Taxpayer contracted to purchase the Property on 24 June 1996. The purchase of the Property was completed on 18 July 1996.
- (viii) (a) In his tax returns for the years of assessment 1996/97 to 1998/99, the Taxpayer declared that he had derived the following rental income from the Property:

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
Period of letting :	1-11-1996– 31-3-1997	1-4-1997– 7-8-1997	1-7-1998– 27-11-1998
Rent and other consideration received/receivable :	\$120,000	\$142,903	\$129,360
Rates paid and irrecoverable rent :	\$6,325	\$4,732	\$7,172
Assessable value after deduction of rates paid and irrecoverable rent :	\$113,675	\$138,171	\$122,188

- (b) The Taxpayer claimed deduction of home loan interest \$82,667 in respect of the Property for the year of assessment 1998/99. The Taxpayer stated that he used the Property as his place of residence during the period from 1 April 1998 to 30 June 1998.
- (ix) (a) On divers dates, the assessor raised on the Taxpayer the following salaries tax assessments for the years of assessment 1996/97 to 1998/99:

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
Income - Company A			
[sub-paragraph (v)(d)]	\$501,710	\$183,073	\$329,516
[sub-paragraph (v)(e)]	81,000	-	-
Company C			
[sub-paragraph (iii)]	<u>-</u>	<u>737,419</u>	<u>-</u>
	582,710	920,492	329,516
Residence	<u>20,904<sup>1</sup></u>	<u>18,307<sup>2</sup></u>	<u>32,951<sup>4</sup></u>

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Assessable income	603,614	938,799	362,467
<u>Less:</u> Home loan interest	<u>-</u>	<u>-</u>	<u>82,667</u>
	603,614	938,799	279,800
<u>Less:</u> Basic allowance	90,000	-	108,000
Dependent grandparent allowance	24,500	-	-
Additional dependent grandparent allowance	<u>7,000</u>	<u>-</u>	<u>-</u>
Net chargeable income	<u>\$482,114</u>	<u>\$938,799<sup>3</sup></u>	<u>\$171,800</u>
Tax payable	<u>\$88,622</u>	<u>\$140,819</u>	<u>\$18,706</u>

Notes:

- 1 \$501,710 x 5/12 x 10% [sub-paragraph (v)(e)] = \$20,904
- 2 \$183,073 x 10% [sub-paragraph (v)(e)] = \$18,307
- 3 Tax assessed at standard rate
- 4 \$329,516 x 10% [sub-paragraph (v)(e)] = \$32,951

The Taxpayer did not object against the above assessments.

- (b) To give effect to the Tax Exemption (1997 Tax Year) Order, the tax payable for the year of assessment 1997/98 had been reduced from \$140,819 to \$126,737.
- (x) It has come to the assessor's notice that Company A operated 'Housing Mortgage Interest Subsidy Plan' ('the Subsidy Plan') and 'Home-owner Benefit Scheme' ('the HOB Scheme') for its employees during the relevant time. In response to the assessor's enquiries, Company A provided the following information and documents.

The Subsidy Plan

- (a) The Taxpayer received interest subsidy under the Subsidy Plan.
- (b) The amount of interest subsidy received by the Taxpayer had been included in the total income reported in the employer's return submitted.
- (c) The Subsidy Plan provided by Company A includes, among others, the following terms:

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### ‘ 2. Eligibility

....

The employee must be named as (one of) the mortgagor(s). He or she must live in the Property to be financed, and not use the Property for any other commercial gain....

### 11. Others

....

c. Employees must live in the Property subsidized under the Plan, and must not let out any part of the Property.’

### The HOB Scheme

(d) The HOB Scheme provided by Company A contains terms including the following:

- ‘ 1. For the tax advantage of a permanent staff member who owns and occupies his residence, and is at the grade E2 or above, [Company A] may enter with him into a tenancy agreement for the sole purpose of providing the property back to the staff member as his personal residence.
2. The tax treatment will be as follows:
  - a. The staff member would still be entitled to the housing refund arrangement in “Housing Allowance” above, and 10% of the total cash would be added as taxable rental value of the residence.
  - b. The staff member as a landlord would have to include the rental income received for property tax purpose which means that he would be subject to property tax at 15% on 80% of the amount received.
  - c. The staff member could claim personal assessment and deduct any mortgage interest on the property in his personal assessment form.

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...

4. No deposit whatsoever would be payable by [Company A] under the tenancy agreement.

...

6. The period of the tenancy would be for 12 months or less up to 31 March of each tax year.

7. The tenancy agreement would include an early termination clause capable of being exercised by either party at any time upon immediate notice. This translates that the tenancy in any event will be terminated immediately upon termination of the applicant's employment with [Company A].'

- (xii) The assessor considered that the rental payments made to the Taxpayer by Company A were cash allowances. The assessor raised on the Taxpayer the following additional salaries tax assessments for the years of assessment 1996/97 to 1998/99:

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>
	\$	\$	\$
Income [sub-paragraph (ix)(a)]	582,710	920,492	329,516
Rental payments [sub-paragraph (v)(e)]	<u>120,000</u>	<u>142,903</u>	<u>129,360</u>
	702,710	1,063,395	458,876
<u>Less:</u> Home loan interest [sub-paragraph (viii)(b)]	<u>-</u>	<u>-</u>	<u>82,667</u>
	702,710	1,063,395	376,209
<u>Less:</u> Basic allowance	<u>-</u>	<u>-</u>	<u>108,000</u>
Dependent parent allowance	-	-	-
Additional dependent parent allowance	<u>-</u>	<u>-</u>	<u>-</u>
Total net chargeable income*	702,710#	1,063,395#	268,209
<u>Less:</u> Already assessed			



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[sub-paragraph (ix)(a)]	<u>482,114</u>	<u>938,799</u>	<u>171,800</u>
Additional net chargeable income	<u>220,596</u>	<u>124,596</u>	<u>96,409</u>
Tax payable on * above	105,406	143,558	35,095
<u>Less: Already assessed</u> [sub-paragraphs (ix)(a)&(b)]	<u>88,622</u>	<u>126,737</u>	<u>18,706</u>
Additional tax payable	<u>16,784</u>	<u>16,821</u>	<u>16,389</u>

# Tax assessed at standard rate

- (xii) The Taxpayer objected against the above additional salaries tax assessments on the ground that the rental payments paid by Company A to him should not be regarded as cash allowances. He claimed that:

‘The fact that I rented the property to [Company A] is a legal one. The tenancy is supported by a duly stamped tenancy agreement and relevant rental receipts.’

- (xiii) The assessor raised enquiries with Company A on the leasing of the Property from the Taxpayer during the relevant times. In reply, Company A supplied the following documents and information:

- (a) Copies of stamped tenancy agreements in respect of the Property entered into by the Taxpayer and Company A showed the following details:

	<b>Appendix C</b>	<b>Appendix C1</b>	<b>Appendix C2</b>
Date	31-10-1996	27-3-1997	23-6-1998
Term of lease	5 months	12 months	9 months
Period covered	1-11-1996– 31-3-1997	1-4-1997– 31-3-1998	1-7-1998– 31-3-1999
Monthly rent	\$30,000	\$35,000	\$26,400
Payment date	The last day of each month	The last day of each month	The last day of each month
First payment date	1-12-1996	1-5-1997	1-8-1998

- (b) Copies of 14 rental receipts issued by the Taxpayer, as landlord of the Property, to Company A for the periods from November 1996 to July 1997 and from July 1998 to November 1998 show the following details:

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Date of receipt	Rental period	Amount \$
30-11-1996	1-11-30-11-1996	30,000
31-12-1996	1-12-31-12-1996	30,000
31-1-1997	1-1-31-1-1997	30,000
28-2-1997	1-2-28-2-1997	30,000
31-3-1997	1-3-31-3-1997	30,000
30-4-1997	1-4-30-4-1997	35,000
31-5-1997	1-5-31-5-1997	35,000
30-6-1997	1-6-30-6-1997	35,000
31-7-1997	1-7-31-7-1997	35,000
31-7-1998	1-7-31-7-1998	26,400
31-8-1998	1-8-31-8-1998	26,400
30-9-1998	1-9-30-9-1998	26,400
31-10-1998	1-10-31-10-1998	26,400
30-11-1998	1-11-27-11-1998	23,760

(c) The monthly rent was paid to the Taxpayer in one lump sum together with his basic salary.

(xiv) In response to the assessor's enquiries, Company A stated that:

(a) The Taxpayer was at the grade of assistant vice president from 1 April 1996 to 7 August 1997, and vice president from 1 June 1998 to 28 November 1998, both under the staff grading of E2.

(b) '... our payment of rent was made one month in arrears. The rent for July 1998 was paid in August 1998.... The receipt issued by (the Taxpayer) to us on 31 July 1998 was for our ease of administration.'

(c) '([Company A] does) operate a provident fund scheme. [Company A's] policy is that both the company and employees have to contribute a certain % of the latter's monthly pay (which includes basic salary, and where appropriate, housing allowance) to the fund scheme.'

(xv) At the assessor's request for copies of payroll during the periods of his employment with Company A, the Taxpayer supplied copies of the following 10 salary advices:

Period	Salary	Rental payment	Housing allowance	Guaranteed bonus	Provident fund contribution	Net payment
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	(A)	(B)	(C)	(D)	(E)	(A)+(B)+(C) +(D)-(E)
1-12-						
31-12-1996	\$15,000	\$30,000	\$8,482.46		\$(2,250)	\$51,232.46
1-1-						
31-1-1997	15,000	30,000	8,353.08		(2,250)	51,103.08
1-3-						
31-3-1997	15,000	30,000	8,094.31		(2,250)	50,844.31
1-4-						
30-4-1997	24,000	30,000	7,964.92	\$45,000	(2,700)	104,264.92
1-5-						
31-5-1997	19,000	35,000	7,835.54		(2,700)	59,135.54
1-6-						
30-6-1997	19,000	35,000	7,706.15		(2,700)	59,006.15
1-7-						
31-7-1997	19,000	35,000	7,576.77		(2,700)	58,876.77
1-6-						
30-6-1998	\$66,000	-	-		\$(3,300)	\$62,700.00
1-7-						
31-7-1998	66,000	-	\$2,652.83		(3,300)	65,352.83
1-8-						
31-8-1998	39,600	\$26,400	9,147.65		(3,300)	71,847.65

(xvi) In correspondence with the assessor, the Taxpayer made the following allegations:

- ‘ 1. ...the Inland Revenue Department (‘ IRD’ ) in principle accepts such arm’s length arrangement and requires the drawing of a tenancy agreement .... The additional assessments in question are contradicting the established principle of IRD.
2. The arrangement concerned is at arm’s length. This is evidenced by:
  - i) The agreement has been duly signed and stamped on a timely manner.
  - ii) The rent is set on a mutually acceptable level.
  - iii) The rent is at market rate as compared to the ratable (sic) value evaluated by the Rating and Valuation Department. For your information, the ratable (sic) value of the premises in question is HKD276000 (premise) + HKD25200 (car park) in the fiscal year 1996/97 and HKD351300+25200 in the year 1997/98 and 1998/99.

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- iv) Property tax of the premises has been filed, duly assessed and settled.’

### **The cases of the parties**

4. The respective cases of the Taxpayer and the Commissioner have been set out with the relevant facts in paragraph 3 above and need not be repeated here.

### **The law**

5. The relevant part of section 8 of the IRO provides as follows:

**‘8. Charge of salaries tax**

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

*(a) any office or employment of profit; and*

*(b) any pension.’*

6. The relevant parts of section 9(1) of the IRO provide as follows:

*‘(1) 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;’*

7. The relevant part of section 9(2) of the IRO provides as follows:

*‘(2) 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 after deducting the outgoings, expenses and allowances provided for in section 12(1)(a) and (b) to the extent to which they are incurred during the period for which the*

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*place of residence is provided and any lump sum payment or gratuity paid or granted upon the retirement or termination of employment of the employee.'*

8. Section 61 of the IRO provides as follows:

***'61. Certain transactions and dispositions to be disregarded***

*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.'*

(emphasis supplied)

9. Section 68(4) of the IRO provides that:

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

### **Our conclusion**

10. Having considered all the evidence and the arguments of the parties, we are of the opinion that the rental paid by Company A as tenant to the Taxpayer as landlord is part of the remuneration package paid by Company A as employer to the Taxpayer as employee. It forms part of the income from the Taxpayer's employment by Company A within the meaning of section 9(1) of the IRO and is therefore taxable under section 8(1) of the IRO.

11. To begin with, the labelling of a payment by an employer to an employee is not conclusive. It is always a question of fact as to what the true nature of the payment is. It is the substance rather than the form or label which is determinative. See the previous decision of the Board of Review in Case D8/82, IRBRD, vol 2, 8 and the case of CIR v Peter Leslie Page (HCIA 2/2002 Judgment of Mr Recorder Edward Chan SC delivered on 14 November 2002).

12. In the present case, we note the following facts:

- (i) It was not provided in the employment contracts between Company A and the Taxpayer that the latter was entitled to any housing benefit or provision of free staff quarters.

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- (ii) The 'rental' paid by Company A to the Taxpayer together with his 'salary' would always be equivalent to the pre-determined amount of the remuneration payable by the Company A to the Taxpayer under the employment contracts.

13. We further note the following unusual features in the three tenancy agreements between the Taxpayer and Company A which one would not find in normal arms-length tenancy agreements:

- (i) The rental was payable in arrear [Clause 1].
- (ii) The tenancy was to be terminated upon termination of the employment of the landlord with the tenant [Clause 7].
- (iii) The landlord was to pay all the charges for electricity, telephone, water, gas and other utility charges in respect of the Property [Clause 3(e)].
- (iv) All stamp duty was borne by the landlord [Clause 4(b)].
- (v) The tenant was indemnified from claims in respect of any loss damage or injury to person or property sustained [Clause 6].
- (vi) The tenant was not required to pay any rental deposits.
- (vii) On the one hand, it was stipulated in the tenancy agreements that the rental for each month was to be paid in arrear on the last day of each and every month; on the other hand, it was stated that the first of such payments was to be on the first day of the month following the month in which the term of the lease would commence.

14. Furthermore, the letting out of the Property by the Taxpayer is clearly in contravention of the terms of the Subsidy Plan as set out in paragraph 3(x) above.

15. In all the circumstances, we are of the opinion that there is ample justification for the Commissioner to have come to the view that the tenancy agreements and the landlord and tenant relationship between the Taxpayer and Company A are 'fictitious' or at least 'artificial' within the meaning of section 61 of the IRO. See the previous decisions of the Board of Review in Cases D77/99, IRBRD, vol 14, 528, D93/01, IRBRD, vol 16, 784 and D105/00, IRBRD, vol 15, 897.

16. In his grounds of appeal dated 20 February 2004, one of the grounds is that the Commissioner had erred by ignoring what is described as the 'Assessment Policy' which is put thus by the Taxpayer:

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### 'B. The Assessment Policy

The Assessment Policy is that “the Commissioner accepts in principle that a taxpayer can wear both the hat of an employee and a landlord at the same time and **if the arrangement is genuine and arm’s length and reasonable one, it will not be challenged**. The Commissioner will take into account factors such as whether there is a duly stamped lease, whether the rent is at market value, whether the rental income is reported by the employee as liable to property tax, whether the rent paid is reasonable in relation to the overall employment package and whether the house benefit is provided for in the contract of employment.” [Paragraph 3693.1 of Encyclopedia of Hong Kong Taxation 3 – Taxation of Income by PF Willoughby and AJ Halkyard] (Annexure 1).’

(emphasis supplied)

We take the view that the words in the abovementioned quotation which have been emphasized in fact are of greater assistance to the Commissioner as opposed to the Taxpayer.

17. In all the circumstances, we are of the view that the Taxpayer has not been able to discharge the burden imposed upon him by section 68(4) of the IRO of proving that the assessments appealed against are excessive or incorrect.

18. We therefore dismiss the Taxpayer’s appeal and confirm the Commissioner’s Determination to assess the Taxpayer for additional salaries tax as set out in paragraph 2 above.