INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D47/00

Salaries tax – whether a transaction entered into was for the sole or dominant purpose of obtaining a tax benefit – objective test to be applied under section 61A – sections 61A and 68 of the Inland Revenue Ordinance (' IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), David Lam Tai Wai and Michael Seto Chak Wah.

Date of hearing: 24 June 2000.
Date of decision: 28 July 2000.

The taxpayer appealed against the determination of the Commissioner of Inland Revenue dated 21 December 1999 whereby additional salaries tax assessment for three respective years of assessment were made against the taxpayer under section 61A of the IRO. The ground of appeal was that ' the relevant transactions amongst Company A, Company B and the taxpayer were not entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit and section 61A of the IRO was not applicable to the taxpayer' s case.'

Held :

1. The onus of proving that the assessment appealed against was excessive or incorrect shall be on the taxpayer: section 68(4) of the IRO.

2. The tests set out in section 61A of the IRO have to be applied objectively: Yick Fung Estates Limited v CIR [2000] 1 HKLRD 381 at 399.

3. In ascertaining the net assessable income of a person for the purpose of salaries tax, only outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, which are ' wholly, exclusively and necessarily incurred in the production of the assessable income' may be deducted under section 12(1)(a) of the IRO. The test for deduction of expenses for profits tax is less stringent. Although there is the same exclusion for ' domestic or private expenses' [section 17(1)(a)], ' all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period' may be deducted under

section 16(1). In practice, many deductions which are allowed for profits tax purposes will be disallowed for salaries tax purpose.

4. It was clear on the evidence before the Board of Review that Company A was the taxpayer' s alter ego.

5. By interposing Company A, what would have been the taxpayer' s salary had been presented to the Revenue as profits of Company A. The tax benefit to the taxpayer lied in the much greater amounts of expenses which might lawfully be allowed. In practice and in fact, what were claimed to be expenses of Company A were allowed by the Revenue as deductions in computing its assessable profits.

6. Factors laid down in sections 61A(1)(a), (b) and (c) all point strongly to the conclusion that, the taxpayer who was one of the persons who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling himself to obtain a tax benefit. Company A had no real role in the transaction. Its involvement was quite artificial.

7. The other factors laid down in section 61A(1) were either inapplicable or at best marginally relevant.

8. Looking at the matters globally, the overall conclusion of the Board of Review was that the sole or dominant purpose was the obtaining of a tax benefit. Section 61A was therefore correctly invoked against the taxpayer.

9. The taxpayer had failed to discharge the burden under section 68(4) and his appeal failed.

Appeal dismissed.

Cases referred to:

Yick Fung Estates Limited v CIR [2000] 1 HKLRD 381
D78/94, IRBRD, vol 10, 66

Fung Chin Keung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 21 December 1999 whereby:

(1) Additional salaries tax assessment for the year of assessment 1991/92 dated 31 March 1998, showing additional assessable income of $887,925 with additional tax payable of $146,738 was increased to additional assessable income of $896,925 with additional tax payable of $148,088.

(2) Additional salaries tax assessment for the year of assessment 1992/93 dated 31 March 1998, showing additional assessable income of $630,000 with additional tax payable of $108,850 was confirmed.

(3) Additional salaries tax Assessment for the year of assessment 1993/94 dated 31 March 1998, showing additional assessable income of $1,282,581 with additional tax payable of $209,687 was confirmed.

The facts

2. The Taxpayer has not challenged the following background facts taken from the statement of facts in the determination, we find them as facts.

3. Company A is a private company incorporated in Hong Kong on 29 April 1988. At the relevant time, Company A had an issued capital of two shares of $1 each. The two shares were owned by the Taxpayer and his wife respectively. The Taxpayer was also one of the two directors of Company A. The business address of Company A was the same as the residential address of the Taxpayer. In its accounts for the years of assessment 1991/92 to 1993/94, Company A described the nature of its business as provisions of editorial and management consultancy services.

4. Company A and the Taxpayer entered into an agreement (' Agreement I') with Company B dated 8 February 1990. Agreement I was terminated on 29 February 1992.

5. Company A and the Taxpayer entered into another agreement (' Agreement II') with Company B dated 1 September 1992.

6. Agreement II was superseded by an agreement dated 15 July 1993 (' Agreement III') entered into by Company A, the Taxpayer and Company B.

7. Agreement III was terminated on 31 July 1994.

8. Agreement I, II and III shall be referred to collectively as ' the Agreements' . Pursuant to the Agreements, Company B paid the following fees to Company A in the years of assessment

1991/92 to 1993/94:

Year of assessment	**Fee paid ($)**	**Period covered**
1991/92	992,925	1-4-1991 to 29-2-1992
1992/93	630,000	1-9-1992 to 31-3-1993
1993/94	1,452,581	1-4-1993 to 31-3-1994

9. On divers dates, Company A filed profits tax returns for the years of assessment 1991/92 to 1993/94. The following extracts were made from the returns and information supplied:

Year of assessment	**1991/92**	**1992/93**	**1993/94**
Basis period : year ended	31-3-1992	31-3-1993	31-3-1994
	$	$	$
Income from			
Company B	992,825	603,000	1,452,581
Company C	75,000	394,435	-
Others	100	27,000	-
	1,067,925	1,024,435	1,452,581
Add:			
Gain on disposal of fixed assets	-	35,249	-
	1,067,925	1,059,684	1,452,581
Less:			
Accountancy fee, secretarial fee and audit fee	11,650	12,350	14,000
Bank charges	200	466	212
Business registration fee	1,000	1,150	1,250
Depreciation	187,887	199,632	227,183
Donation	500	500	500
Electricity and water	8,719	7,768	11,009
Entertainment	126,375	114,278	162,501
Hire charge	25,738	31,266	16,508
Loss on disposal of fixed assets	-	-	35,984
Management fee	3,000	3,000	4,200
Motor vehicle expenses	116,129	115,793	162,345
Office supplies	10,133	8,821	10,145
Repairs and maintenance	1,150	13,470	2,050
Rent and rates	9,366	6,666	9,366
Salaries	384,100	330,954	394,200
Staff welfare	4,500	1,100	1,090
Sundry	3,950	-	19,694
Telephone	1,113	1,735	1,557

Travelling	-	21,140	12,286
Net profit	172,415	189,595	363,501
Assessable profits as per tax computation	137,655	105,560	234,627

The income from Company C was for services provided during the period from March 1992 to August 1992.

10. In his tax returns for the years of assessment of 1991/92 to 1993/94, the Taxpayer declared the following income from employment:

Year of assessment	**1991/92**	**1992/93**	**1993/94**
Employer	-	Company A	-
Capacity in which employed	-	Director	-
Period of employment	1-4-1991 to 31-3-1992	1-4-1992 to 31-3-1993	1-4-1993 to 31-3-1994
Salaries ($)	105,000	133,000	170,000

11. The assessor raised on the Taxpayer the following salaries tax assessments per returns:

Year of assessment	**1991/92**	**1992/93**	**1993/94**
	$	$	$
Assessable income [paragraph 10]	105,000	133,000	170,000
Less : Allowances	65,000	73,000	90,000
Net chargeable income	40,000	60,000	80,000
Tax payable thereon	2,200	5,600	8,200

The Taxpayer did not object to the assessments.

12. Upon review, the Commissioner was of the view that for the Agreements, the interposition of Company A in the arrangement was for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit. The Commissioner considered the income form Company B should be regarded as the salary income of the Taxpayer and raised on the Taxpayer the following additional salaries tax assessments for the years of assessment 1991/92 to 1993/94 under section 61A of the IRO, Chapter 112:

Year of assessment	**1991/92**	**1992/93**	**1993/94**
	$	$	$
Income from			
Company A	-	133,000	-
Company B [paragraph 8]	992,925	630,000	1,452,581

Assessable income	992,925	763,000	1,452,581
Less : Income already assessed [paragraph 11]	105,000	133,000	170,000
Additional assessable income	887,925	630,000	1,282,581
Tax payable thereon	148,938	114,450	217,887
Less : Tax already charged [paragraph 11]	2,200	5,600	8,200
Additional tax payable	146,738	108,850	209,687

13. The Taxpayer, through Moores Rowland, formerly known as Thomas Lee & Co Limited, (' the Representative'), objected to the three additional assessments on the ground that the assessments were excessive. He claimed that the entering into a contract for services by Company A and his fulfilling of the terms of the contract in the capacity of an employee of Company A was not a transaction solely and dominantly for the purpose of obtaining a tax benefit and hence section 61A of the IRO should not be applicable to his case.

14. The assessor had raised enquiries with Company A on the expenses charged in its profits and loss accounts. Up to date of the determination, Company A had not replied to the enquiries raised.

15. The assessor had ascertained that the Taxpayer had received an income of $9,000 from his part-time employment with a tertiary college during the period from 1 April 1991 to 30 June 1991.

16. The assessor proposed to revise the additional salaries tax assessment for the year of assessment 1991/92 as follows:

	$
Income already assessed [paragraph 12]	992,925
Add : Income from the tertiary college [paragraph 15]	9,000
Assessable income	1,001,925
Less : Income assessed in the original assessment	105,000
Revised additional assessable income	896,925
Tax payable thereon on $1,001,925	150,288
Less : Tax charged in the original assessment	2,200
Revised additional tax payable	148,088

17. The Commissioner concluded that both sections 61 and 61A of the IRO were applicable and issued the determination referred to in paragraph 1 above.

Ground of appeal

18. By letter dated 20 January 2000, the Representative gave notice of appeal on behalf of the Taxpayer. The ground of appeal is that ' the relevant transactions amongst [Company A, Company B and the Taxpayer] were not entered into or carried out for the sole or dominant purpose of enabling [the Taxpayer] to obtain a tax benefit and section 61A of the IRO is not applicable to [the Taxpayer' s] case' .

Our decision

19. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the Taxpayer.

20. Section 61A provides that : -

> *' (1) This section shall apply where any transaction has been entered into or effected after [14 March 1986] ... 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 persons, to obtain a tax benefit.'

Subsection (3) provides that 'tax benefit' means 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof' and 'transaction' includes a 'transaction, operation or scheme'.

21. As Rogers JA laid down in Yick Fung Estates Limited v CIR [2000] 1 HKLRD 381 at page 399 :

'... the tests set out in s. 61A have to be applied objectively.

There are seven matters (a) to (g) to which the section requires that regard must be had. On a clear construction of the subsection, the section would not be relevant or the subject matter of consideration unless there was a tax benefit, in other words, the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. In this case, it is said that there has been an avoidance of tax in respect of HK$108,327,586 profits or at any rate, there has been a reduction in the amount of tax that would otherwise have been payable. On that basis, the various matters at (a) to (g) have to be considered and if upon that exercise, the conclusion would be arrived at that the person who entered into or carried out the transaction did so for the sole or dominant purpose of obtaining a tax benefit, the Assistant Commissioner may exercise one of the two powers set out in sub-s.(2).

In this court, there was some discussion as to whether it is necessary for more than one item in matters (a) to (g) 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 an 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 his own common sense and

> *apply the results of his deliberations in respect of each matter and come to an overall conclusion.*
>
> *... The Board approached the matter on the basis that the word ' form' related to the legal effect or, as I would put it, the legal nature of the transaction and that the substance related to the practical or commercial end result of the transaction. In that respect, I would have no cause to disagree with the way in which this was put.'*

22. What is in issue in this case is the transaction or operation or scheme (' the transaction') whereby Company A was interposed in the relationship between Company B and the Taxpayer and whereby Company A was named in the Agreements as a contracting party in addition to Company B and the Taxpayer as the other two contracting parties.

23. In considering the manner in which the transaction was entered into and carried out, we must start a few months before the date of Agreement I when in substance the relationship between Company B and the Taxpayer started off with the Taxpayer becoming an employee (by whatever name so called, whether a consultant or an adviser or otherwise) of Company B.

24. In September 1989, the Taxpayer filled in an ' employment application' of Company B applying for the position of ' news & public affairs manager' . According to the section for office use only, Company B offered the Taxpayer the position of ' deputy controller' in the news and public affairs department; recorded the Taxpayer' s employee number and that his actual commencing date was 1 September 1989; and noted that the ' contract of appointment of the Taxpayer is being prepared by Mr D' s office' .

25. The ' contract of appointment' took the form of an agreement dated 1 September 1989 between Company B and Company A as consultant whereby Company B appointed Company A as consultant from 1 September 1989 to 31 August 1991 and Company A should provide Company B with the benefit of the advice and assistance of the Taxpayer as the adviser and procure the Taxpayer to serve Company B as deputy controller of news and current affairs of Company B. Clause 5 provided, among others, that Company A should procure the Taxpayer to devote substantially the whole of his time, attention and skill to the discharge of duties of his office as deputy controller of news and current affairs of Company B and faithfully and diligently perform such duties. Significantly, by a letter of undertaking, the Taxpayer undertook and confirmed that ' I am primary (sic) liable to Company B and shall perform and discharge all the obligations and undertakings required of the consultant and the adviser set out in the annexed agreement' .

26. Agreement I dated 8 February 1990 came into existence five months later. In contrast with the 1989 agreement, Agreement I was a tri-parte agreement, with the Taxpayer being added as a party (as ' the adviser') to the agreement. The addition of the Taxpayer is significant in that Agreement I was enforceable against and by the Taxpayer. By Clause I, Company B appointed

Company A ' as consultant by providing [Company B] with the services of the adviser hereinafter described' . The term was from 1 March 1990 to 28 February 1993. Clause 2 provided that Company A ' shall provide [Company B] with the benefit of the advice and assistance of [the Taxpayer] ... shall procure that [the Taxpayer] shall serve [Company B] as controller of news & public affairs of [Company B] and [the Taxpayer] undertakes to guarantee the performance of this agreement by [Company A]. Clause 5 provided that Company A ' shall make available to [Company B] the advice and assistance of [the Taxpayer] in connection with the business of [Company B] ... shall procure that [the Taxpayer] shall ... devote substantially the whole of his time, attention and skill to the discharge of duties of his office as controller of news & public affairs of [Company B and] faithfully and diligently perform such duties and exercise such powers consistent with his office in relation to [Company B]' .

27. In our decision, although Agreement I was in form a tri-parte agreement, it is clear from the terms of the agreement as a whole and Clauses 1, 2 and 5 which we have referred to and other clauses such as 6(B), 7(A)(ii) & (B), 8, and 10 in particular that in substance Company B was employing the Taxpayer as its controller of news & public affairs.

28. That the substance of the relationship between Company B and the Taxpayer under Agreement I was one of employer and employee is evidenced by the Taxpayer's letter of resignation dated 6 December 1991 to the chief executive officer of Company B, whereby the Taxpayer in his own words stated that (emphasis added) :

> ' **I was employed by Company B** for my journalistic knowledge and experience. I was entrusted with the very important responsibility as controller of news because, I believe, of my impartiality and integrity. However, changing circumstances are inhibiting me from discharging my duty according to my professional conscience as a journalist. I wish, therefore, to tender my resignation.'

29. Agreement II dated 1 September 1992 is again a tri-parte agreement, with the Taxpayer being ' the adviser' . Clauses 1, 2 and 5 are the same as Clauses 1, 2 and 5 of Agreement I except that under Agreement II, what Company A was to make available to Company B under Clauses 2 and 5 included ' the service' of the Taxpayer.

30. In our decision, although Agreement II was in form a tri-parte agreement, it is clear from the terms of the agreement as a whole and Clauses 1, 2 and 5, 7(A)(ii) & (B), and 9 in particular that in substance Company B was employing the Taxpayer as its controller of news & public affairs.

31. Agreement III is dated 15 July 1993, superceding Agreement II. In our decision, although Agreement III was in form a tri-parte agreement, it is clear from the terms of the agreement as a whole and Clauses 1(A), 2, 4, 5, 7(A)(ii), and 8 in particular that in substance Company B was employing the Taxpayer as its assistant chief executive officer.

32. That Agreement III was the Taxpayer's employment contract is evidenced by his memo dated 20 December 1993 where the Taxpayer referred to Agreement III in these terms (emphasis added) :

> ' ... I wish to take this opportunity to recapture our conversation in your office prior to the signing of **my employment contract** in July this year ... I wish to put on the record this understanding and hope that you and Company B will view this as an addendum to **my employment contract with Company B**' .

33. In his resignation letter in Chinese dated 9 February 1994, the Taxpayer repeatedly referred to himself as an employee '**職員**' .

34. In ascertaining the net assessable income of a person for the purpose of salaries tax, only outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, which are 'wholly, exclusively and necessarily incurred in the production of the assessable income' may be deducted under section 12(1)(a) of the IRO. The test for deduction of expenses for profits tax is less stringent. Although there is the same exclusion for 'domestic or private expenses' [section 17(1)(a)], 'all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period' may be deducted under section 16(1). In practice, many deductions which are allowed for profits tax purposes will be disallowed for salaries tax purpose.

35. It is clear on the evidence before us that Company A was the Taxpayer's alter ego.

36. By interposing Company A, what would have been the Taxpayer's salary had been presented to the Revenue as profits of Company A. The tax benefit to the Taxpayer lied in the much greater amounts of expenses which might lawfully be allowed. In practice and in fact, what were claimed to be expenses of Company A were allowed by the Revenue as deductions in computing its assessable profits.

37. Factors (a), (b) and (c) all point strongly to the conclusion that, the Taxpayer who was one of the persons who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling himself to obtain a tax benefit. Company A had no real role in the transaction. Its involvement was quite artificial.

38. The other factors are either inapplicable or at best marginally relevant.

39. Looking at the matters globally, out overall conclusion is that the sole or dominant purpose was the obtaining of a tax benefit.

40. In our decision, section 61A was correctly invoked against the Taxpayer.

41. D78/94, IRBRD, vol 10, 66 which the Taxpayer cited is a decision on the facts of that case and we derive no assistance from it.

42. The Taxpayer has failed to discharged the burden under section 68(4) and his appeal fails.

43. We dismiss the appeal and confirm the assessment referred to in paragraph 1(1) above as increased by the Commissioner and confirm the assessment referred to in paragraph 1(3) above. We would have confirmed the assessment referred to in paragraph 1(2) above but for the Respondent's (the Revenue's) concession referred to below.

The Respondent's (the Revenue's) concession

44. In the course of the hearing of the appeal, we asked Mr Fung who appeared for the Respondent about the inclusion of the sum of $133,000 as income from Company A in the year of assessment 1992/93 [see paragraph 12 above]. Mr Fung told us that as Company A had received $394,435 in the year of assessment 1992/93 from Company C [paragraph 9], $133,000 was treated as the Taxpayer's income from Company A on account of Company A's receipts from Company C. We asked Mr Fung whether one could say that $133,000 came from Company C instead of Company B and whether the Taxpayer would have been paid $133,000 by Company A if Company A had not received $630,000 from Company B. After further discussions, Mr Fung advised us that in the event of the Taxpayer failing in his appeal, the Respondent would concede this item of $133,000 on an entirely without prejudice basis.

45. In the light of the Respondent's concession, we remit the assessment referred to in paragraph 1(2) above to the Respondent to revise it to give effect to the concession.