Case No. D4/93

Salaries tax – taxpayer absent from work and provided a replacement to perform his duties – whether payment made by taxpayer to replacement was deductible against assessment income of taxpayer.

Panel: Howard F G Hobson (chairman), Paul Tong Hon To and Peter C White.

Date of hearing: 11 January 1993.
Date of decision: 26 April 1993.

The taxpayer was employed as a full time employee in Hong Kong. He was absent from Hong Kong for certain periods of time when he recruited the services of his brother-in-law to perform his duties. He made a payment to his brother-in-law of an amount equal to the amount paid to the taxpayer in respect of the period that he was absent from work. It was argued on behalf of the Commissioner that the payment by the taxpayer to his brother-in-law was not a payment made in the performance of his duties by the taxpayer.

Held:

The Board agreed that the payment made by the taxpayer to his brother-in-law had not been wholly, exclusively and necessarily expended in the performance of the duties by the taxpayer. Furthermore the taxpayer was not acting as an agent for his employer and accordingly the payment was not deductible against the assessable income of the taxpayer.

Appeal dismissed.

Cases referred to:

CIR v Humphrey 1 HKTC 451
D17/93, IRBRD, vol 1, 113
D50/89, IRBRD, vol 4, 527
D46/92, unreported
Ricketts v Colquhoun [1926] AC 1
D67/87, IRBRD, vol 3, 97

Maria Tsui for the Commissioner of Inland Revenue.
Taxpayer in person.

Majority Decision: (By the Chairman and Mr Paul Tong Hon To)

During the tax year 1987/88 the Taxpayer was employed by a company (X Company) as a monthly rated permanent worker. During the relevant year X Company paid into his bank account a total of $101,319 of which $93,899 represented salary and $7,420 was by way of bonus. In his salaries tax return, the Taxpayer included the bonus of $7,420 but showed his salary as $86,853 which $7,046 less than the amount he had in fact received from X Company. He did this because he had paid $7,420 to his brother-in-law who, with X Company's permission (or perhaps more accurately it took no objection), acted as his replacement on two occasions when the Taxpayer went to mainland China. The first visit was prompted by his father's illness, the second by his death: the total number of days of absence was 27. The Taxpayer's return was accompanied by a letter from X Company confirming that the Taxpayer had engaged a replacement at a total salary of $7,042. An assessment was raised which, inter alia, added back the $7,042 to bring the Taxpayer's principal income back up to $101,319. The relevant part of the Taxpayer's objection to this assessment reads as follows:

> 'I, the applicant, of file re: [no specified], refer to tax return for the year of assessment 1987/88, the total salary was $101,319. During that year, I have returned to my home village twice for a total of 27 days. I have found a replacement for my job and paid him salary of $7,200 in total, while I only got $94,199. The dates of my stay in the village were shown on the copy of my certificate of identity and the employer's certificate submitted earlier to your department.' [There is a mathematical error above of $158 because the $7,200 should be $7,042]

The Taxpayer also successfully claimed a dependent parent allowance which need not concern us. The Commissioner however upheld the assessment in so far as it included the $7,042 as part of the Taxpayer's taxable income. The assessor and the Commissioner treated the exclusion of the $7,042 from the Taxpayer's return as a claim for a deductible expense under section 12(1)(a) and the Commissioner decided that it was not incurred wholly, exclusively and necessarily in the production of the assessable income.

The foregoing facts were not in dispute. There is however an inherent ambiguity in the objection made by the Taxpayer to the Commissioner since the Taxpayer did not specifically claim the $7,042 as an expenditure. We will revert to this later.

The Taxpayer gave evidence but the only additional facts of any materiality were as follows. It was the Taxpayer not X Company who found the replacement, namely his brother-in-law. The $7,042 the Taxpayer paid to his brother-in-law was exactly the same amount the Taxpayer received from the employer in relation to the 27 days. Had the Taxpayer arranged for a third party to act then it would have cost the Taxpayer one and half times his own wage. The practice of arranging for a substitute worker was common in the manufacturing industry and the rate for a replacement was more or less standard. The Taxpayer frankly admitted that the engagement of the substitute was not his employer's affair.

With regard to section 12(1)(a), the Commissioner's representative pointed out that it was necessary to ask if the expenses were incurred in the production of the assessable income ('the on-duty test') and whether they were wholly, exclusively and necessarily incurred. She also referred us to the following authorities:

CIR v Humphrey 1 HKTC 451
D17/73, IRBRD, vol 1, 113
D50/89, IRBRD, vol 4, 527
D46/92, unreported
Ricketts v Colquhoun [1926] AC1
D67/87, IRBRD, vol 3, 97

Adopting the principals set out in these cases the representative submitted that the $7,042 was not an expense incurred in the production of the assessable income because the Taxpayer was not at the time the expense was incurred in the course of performing the duties of his employment and hence did not meet the on-duty test.

The case law on this subject is comprehensively reviewed in the yet to be published D46/92 and though the facts of that case differ from those before us the following passage is apposite:

> ' Having reviewed the Hong Kong cases which by implication has reviewed the overseas cases we are able to state quite clearly and simply that section 12(1)(a) of Inland Revenue Ordinance requires that the outgoing or expense must be "wholly, exclusively and necessarily" incurred and as a separate matter that it must be incurred "in the production of the assessable income". In relation to this second test the expense must be incurred while the Taxpayer is on duty and in the performance of his duties. There must be a perceived connection between the expense and the duties and the perceived connection must be the same as or have no wider meaning than "on duty and in the course of the duties."'

Applying this to the present case it is quite clear that the appeal by the Taxpayer fails on this second ground as well as on the first. The studies of the taxpayer in D46/92 did not take place whilst he was performing the duties of an assistant manager in Hong Kong. The work that he performed in Country X in undertaking the diploma course was something which he did of his own volition so that he would be better qualified and would become in due course a member of the Hong Kong Society of Accountants. His employment was as an assistant manager of an accounting firm in Hong Kong. His studies were not part of his duties and accordingly were not incurred by him 'in the production of the assessable income'.

With the above in mind we agree with the remarks of the Commissioner's representative namely: 'It is conceded that the substitute worker was in fact performing the Taxpayer's duties during the Taxpayer's leave periods. However, as far as the Taxpayer

was concerned, he was not on duty during the leave periods. He did not incur the expenses in the performance of his duties. On the contrary, he incurred the expenses in order to free himself from performing the duties.' On that ground alone therefore in our opinion the Taxpayer's claim must fail. Whilst there is little point in examining the question of whether the $7,042 was wholly, exclusively and necessarily expended, for the sake of completeness we would add that the Taxpayer's absence was voluntary, in the sense that it was of a personal nature not dictated by his work, and the expense cannot therefore be said to have been necessary.

The question whether the action of the Taxpayer in paying the $7,042 to the replacement could be treated as an act of agency on behalf of X Company was raised by Mr Peter White who is delivering a dissenting opinion. The Commissioner's representative responded to the effect that there was no evidence of agency from which any such inference could be drawn. Indeed the very fact of paying the Taxpayer in full for the time he was away would negate any agency for if X Company was responsible for payment to the replacement then he would have deducted the $7,042 from the Taxpayer's wages. However having said this the representative then produced a supplementary submission thereby indicating that consideration had been given by the Revenue to the ambiguity contained in the Taxpayer's objection. In the supplement it was argued that the $7,042 formed part of the Taxpayer's salary within the meaning of section 9(1)(a) because X Company (a) had treated it as such in his return, and (b) had paid it as part of the Taxpayer's monthly income into the Taxpayer's bank account.

We can find no reasonable grounds for inferring that the Taxpayer was acting as agent of X Company when he paid the $7,042 to his brother-in-law.

We therefore dismiss this appeal.

On the basis of the evidence before us we infer and find as a matter of fact that X Company was not the employer of the replacement. Granted it could control the manner in which he did his work but that could not alter the arrangement made between the Taxpayer and the replacement whereby the former in his own capacity paid the latter's wages. Granted further that X Company could be liable to the replacement for any injury be sustained during work but conceivably responsibility in that respect is likely to be founded on the replacement's status as an invitee. Moreover, on the evidence we cannot be sure whether the Taxpayer's arrangement with his brother-in-law was intended to create a legally binding relationship or was simply based on friendly intimacy in which latter case the $7,042 would be a gift.

Though we find against the Taxpayer we have some sympathy for his position, however our duty is to apply the established law to the facts as found.

Minority Decision; (By Mr Peter C White)

Appeal by [the Taxpayer]

The Taxpayer in this matter, a factory worker, was employed by X Company when the ill health of his father necessitated his return to his ancestral home in China.

Recognizing the long-term advantage of retaining the services of the Taxpayer, the employer agreed to permit his temporary departure on condition that he located and introduced a substitute worker.

This the Taxpayer did by the introduction of his brother-in-law which arrangement was accepted by his employer and continued successfully during the Taxpayer's absence over a total period of some 27 days.

During this period (of the employment of the substitute) 'The salary of the substitute worker was $7,042 which was first entered into [the Taxpayer's] account and was later, taken back by the substitute worker.' (see letter from Employer to Commissioner for Inland Revenue dated 6 July 1990.)

The Taxpayer in his return for the relevant period and since that time, has maintained that his employer was not entitled to add the income earned by the substitute to his own, for the purposes of notification to the Inland Revenue Department (IRD) of his own annual earnings. He has been consistent in this contention and has requested the IRD to treat his claim as an application that his total income be reduced by the sum earned by the substitute. The IRD's response however has been to treat his application as an application for a deductible expense and in my view this approach can not be supported.

In this regard I have considered section 8 and 9 of the Inland Revenue Ordinance but can not see how it can be said that the substitute's employment (and salary) constituted part of the Taxpayer's income.

Rather it is important as I see it that we should recognize that a separate contract of employment arose between the employer and the substitute during the period of the Taxpayer's absence. In this regard I hold that:

(1) a contract of employment between the employer and substitute continued for the period of the Taxpayer's absence and could only be terminated by either party according to law;

(2) this contract of employment between the employer and substitute created a legal duty upon the employer to be responsible to the substitute for any negligence at common law by itself or its employees acting in the course of their employment, which caused injury, damage or loss to the substitute.

(3) the contract of employment between the employer and the substitute created a further legal duty upon the employer to provide worker's compensation cover for the substitute.

(4) the contract of employment between the employer and the Taxpayer was suspended during the Taxpayer's absence but continued thereafter with no right of dismissal accruing to the employer as a result of any alleged contract breach by the substitute.

Thus I find that there was a separate contract of employment, unwritten and informal as it was, which bound the employer and substitute during the period of the Taxpayer's absence. It follows that I also hold that the Taxpayer received the sum of $7,042 on behalf of his brother-in-law. This exact sum was indeed immediately paid on and accordingly cannot be characterized as income to the Taxpayer.

(With the greatest of respect to the learned tribunal chairman whose opinion I am unable to join,) I consider that the Commissioner's approach to the Taxpayer's claim was inappropriate and for the abovementioned reasons, that this appeal should now be resolved in favour of the Taxpayer.