Case No. D50/89

Salaries tax – whether special leave pay for overseas study should be included – whether travel and tuition fees are deductible expenses – sections 8 and 12(1)(a) of Inland Revenue Ordinance.

Panel: Robert Wei QC (chairman), Christopher Chan Cheuk and Chiu Chun Bong.

Date of hearing: 17 May 1989.
Date of decision: 14 September 1989.

The taxpayer claimed that leave pay which he received when on special leave in the United Kingdom should not be charged to salaries tax or alternatively that the tuition fee and air passage which he paid to attend a course of study in the United Kingdom should be allowable deductions under section 12(1)(a) of the Inland Revenue Ordinance.

Held:

The taxpayer was employed in Hong Kong and the special leave pay was taxable within the meaning of section 8(1) of the Inland Revenue Ordinance. With regard to the claim to deduct expenses, the tuition fees and air fare were not necessarily incurred by the taxpayer and accordingly were not allowable expenses.

Appeal dismissed.

Cases referred to:

BR 20/69, IRBRD, vol 1, 3
CIR v George Andrew Goepfert 2 HKTC 210
CIR v Humphrey [1970] HKTC 451
Blackwell v Mills [1945] 2 All ER 655
FCT v Hatchett [1971] 125 CLR 494
FCT v Martin [1984] 15 ATR 808
FCT v Smith [1981] 11 ATR 538
Tribunal Case 129, 18 ATR 3943
Brown v Bullock [1961] 1 WLR 1095
BR 17/73, IRBRD, vol 1, 113
BR 19/78, IRBRD, vol 1, 323

Wong Chi Wah for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

1. This appeal concerns the salaries tax assessment for the year of assessment 1986/87 raised on the Taxpayer. He claims (1) that the leave pay which he received for the special leave period from 4 November 1986 to 31 March 1987 which he spent in the United Kingdom should not be charged to tax, or alternatively (2) that the tuition fee and the air passage totalling $56,000 which he paid to enable him to attend a master's degree course during the special leave period in the United Kingdom are allowable deductions under section 12(1)(a) of the Inland Revenue Ordinance, Cap 112.

2. At all material times the Taxpayer was employed by a university in Hong Kong ('the university'). He had applied and had been accepted for a master's degree course at a university in the United Kingdom and was in need of financial support to enable him to read for that course. On the recommendation of the head of his department, the university gave approval for the Taxpayer to be granted special leave from 1 October 1986 to 30 September 1987 to enable him to do so. The grant of the special leave was subject to the following conditions which the Taxpayer accepted:

(a) His untaken annual leave (that is, twenty-six working days as at 30 September 1986) should form the first part of his special leave (that is, 1 October 1986 to 3 November 1986) for which he should receive his normal salary;

(b) The remaining part of his special leave (that is, 4 November 1986 to 30 September 1987) should be on full pay;

(c) The entire period of his special leave should be non-leave-earning for the purpose of calculating his annual leave;

(d) He was required to submit a report on the studies undertaken and a transcript or similar evidence from the university/institution concerned, certifying satisfactory completion of the course within one month of the end of his special leave.

Leave pay

3. Section 8(1) of the Ordinance provides that salaries tax shall be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit. Section 9(1)(a) provides, inter alia, that income from any office or employment includes salary and leave pay.

4. The expression 'income arising in or derived from Hong Kong' is referable to the locality of the source of income: in other words not the place where the duties of the employee are performed but the place where the payment for the employment is made. Therefore, a person employed by a Hong Kong company and who is paid by the company from money originating in Hong Kong to perform services elsewhere is liable to salaries tax because his income arises in or is derived from Hong Kong (BR 20/69, IRBRD, vol 1, 3 at 4 and 5). 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. Regard must first be had to the contract of employment (CIR V George Andrew Goepfert 2 HKTC 210 at 237).

5. In the present case, it is not disputed that the Taxpayer was paid by the university from money originating in Hong Kong to spend his special leave in the United Kingdom. Indeed, the circumstances of the case raise such an inference, and so we find.

6. It follows therefore that the Taxpayer's leave pay was his income arising in or derived from Hong Kong from an office or employment of profit within the meaning of section 8(1) and is chargeable to salaries tax.

7. The Taxpayer contended that he was exempted under section 8(1A)(b). However, to qualify for such exemption, the claimant must, among other things, render outside Hong Kong all the services in connexion with his employment (section 8(1A)(b)(ii)). The Taxpayer obviously does not meet the requirements of sub-paragraph (ii). First, since the charge to salaries tax is referable to a whole year of assessment, it is implicit in sub-paragraph (ii) that it refers to the whole of the year of assessment in question. We therefore cannot accept the Taxpayer's argument that the relevant period is not the year of assessment 1986/87 but the period of special leave from 4 November 1986 to 30 September 1987. That is sufficient to dispose of the Taxpayer's contention. Second, we have to mention that that contention is based on the assumption that the studies he carried on in the United Kingdom were 'services' within the meaning of sub-paragraph (ii). We think that it is very arguable that the studies were not services. However, as the point was not argued, we do not propose to go any further.

Allowable deductions

8. The relevant provisions are contained in section 12(1)(a) which reads as follows:

> ' 12(1) In ascertaining the net assessable income of a person for any year of assessment there shall be deducted from the assessable income of that person –
>
> (a) all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income …'

9. The question in the present case is whether the expenses in question, the tuition fee and the air fares or an appropriate proportion thereof should be deducted from the Taxpayer's assessable income which consisted mainly of salary as from 1 April 1986 to 3 November 1986 and leave pay as from 4 November 1986 to 31 March 1987. That raises two further questions: (a) whether the expenses were incurred in the production of the assessable income; and (b) whether they were wholly, exclusively and necessarily so incurred.

10. Different tests have been used to decide question (a) in the courts in the United Kingdom and their Australian counterparts. The English test was adopted by the Full Court in Hong Kong in CIR v Humphrey [1970] HKTC 451 and has been applied in many cases in Hong Kong since. It asks the question, was the expense incurred at a time when the taxpayer was in the course of performing the duties of his office or employment? As an academic staff member, the Taxpayer's work in the university consisted of both teaching and research. However, we do not think that when attending the master's degree course in London, he was on duty as an academic staff member. His course of study commenced in London on 30 September 1986, and he paid the balance of his tuition fee to the amount of £3,470 on the same day, a deposit of £385 having been paid on 31 July 1986. The sum of £3,470 was therefore not paid when the Taxpayer was on duty and was not an expense incurred in the production of the assessable income. (See Blackwell v Mills [1945] 2 All ER 655.) We shall consider the matter again when we come to deal with question (b).

11. The relevant Australian provisions are contained in section 51(1) of the Income Tax Assessment Act 1936 and are in these terms:

> '(1) All losses or outgoings to the extent to which they are incurred in gaining or producing the assessable income ... shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature ...'

12. In FCT v Hatchett [1971] 125 CLR 494 at 499, Menzies J says, 'In my opinion there must be a perceived connexion between the outgoing and assessable income.' The 'perceived connexion' test was applied in a number of 'self-education' cases. However, in FCT v Martin [1984] 15 ATR 808, the Full Federal Court on appeal said that they did 'not believe that Menzies J was purporting to substitute some new test for the principles well established by earlier authorities'. As was stated by Gibbs CJ and Stephen, Mason and Wilson JJ in FCT v Smith [1981] 11 ATR 538 at 542:

> 'The section does not require that the purpose of the expenditure shall be the gaining of the income of that year, so long as it was made in the given year and is incidental and relevant to the operations and activities regularly carried on for the production of income. What is incidental and relevant in the sense mentioned falls to be determined not by reference to the certainty or likelihood of the outgoing resulting in the connexion with the operations which more directly gain or produce the assessable income.'

On the other hand, in Tribunal Case 129, 18 ATR 3943, whilst disagreeing with the proposition that the existence of a 'perceived connection' between the outgoing and a future source of assessable income is sufficient to satisfy the requirements of section 51 of the Act, the Tribunal apparently did not find any fault with the 'perceived connexion' test, provided the taxpayer remains in the same employment at all material times.

13. In a letter dated 18 March 1986 to the university, the Taxpayer's supervisor states, inter alia, as follows:

> 'This department has been responsible for the teaching of [the Taxpayer's academic specialism] to undergraduate and postgraduate students for many years. With no [such specialist] in post, such teaching had to be undertaken by teachers who were partly trained in [his subject]. With increasing research activities in the department and the faculty as a whole, the limited experience in [that subject area] has become a great obstacle because the advancement of our research programme is now stunted by the lack of an appropriate level of [relevant] expertise. This can only be remedied either by the appointment of [such a specialist] or by sending a suitable person for advanced training. The latter is the only alternative solution for this rather urgent problem.'

[The supervisor's letter goes on to detail the Taxpayer's academic qualifications and achievements, and then continues:]

> 'Thus, I would recommend [the Taxpayer] as the most suitable person to be trained in [the relevant specialism] so that this department and the faculty can keep up with this rapidly developing field. An academic exposure will be extremely useful to provide him with first class training and to establish, for this department, broad base contacts and academic interchange with [other experts in the subject] in the UK.
>
> [The Taxpayer] already applied last year for financial and other support from the university through the usual channels. However, he was given such inadequate assistance that I had to advise him not to pursue his plans for the time being.
>
> This year I should like to bring up his case again through you, because I believe that he should be given full support, equivalent or comparable to [relevant] training leave conditions.
>
> [The Taxpayer] was accepted for a master's degree by a university in the United Kingdom in 1986. For 1987/88 this needs to be re-confirmed in May 1986. The course is comprehensive, advanced and is particularly relevant for [this area of] research in Hong Kong. There is no such provision locally or elsewhere in other countries.

> The following are the details for [the Taxpayer's] needs in order to enable him to study for this course in reasonable comfort and peace of mind.
>
> (a) Tuition fee : HK$40,000
> (b) Return passage : 5,000
> (c) Paid leave for about ten months.
> (This is fair as I am not asking for replacement.)
>
> [The Taxpayer] has applied for the Commonwealth Scholarship and the Sino-British Scholarship, but has not been successful mainly because of age thresholds in the requirements. He has applied to the Technical Training Committee for an overseas training grant last year, but he was refused on the grounds that the grant was not designed to assist staff in obtaining master qualifications.
>
> I feel that this reason is – in [the Taxpayer's] case – fallacious. [The Taxpayer] is already academically qualified and the proposed training is to give him the proper up-grading to be able to cope with the increasing demand on his services.
>
> Finally, I should like to emphasize that [the Taxpayer] is determined to go, even without support. In that case he will leave the university. I hope you do understand that this will mean virtual disaster for our department and a set-back for at least three years.
>
> …'

14. Although the writer of the above letter was not called as a witness, we accept it as evidence and treat the facts and opinions stated therein as true and genuine. We are of the view that the payment of tuition fee and air fares was incidental and relevant to the activities regularly carried on by the Taxpayer in his post at the university and also that there is a sufficient nexus between the outgoing and assessable income. Both the 'incidental and relevant' test and the 'perceived connexion' test are therefore satisfied. Coming back to section 12(1)(a), question (a) whether the expenses were incurred in the production of the assessable income should be answered in the affirmative. It remains, however, to consider question (b).

15. Question (b) turns on the interpretation of the words 'wholly, exclusively and necessarily'. The practice of the Inland Revenue Department in Hong Kong is not to construe the words 'wholly' and 'exclusively' too narrowly but to allow apportionment where expenditure is incurred for more than one purpose so that the part attributable to the employment is allowed, provided the other tests are satisfied. This is in line with the approach adopted in recent cases in the UK (see Willoughby, Hong Kong Revenue Law, vol 2, 2.01/12.9). As for the word 'necessarily', it has been construed to mean essential, so that

mere desirability is not enough. 'The test is not whether the employer imposes the expense but whether the duties do, in the sense that, irrespective of what the employer may prescribe, the duties cannot be performed without incurring the particular outlay' (per Donovan LJ in Brown v Bullock [1961] 1 WLR 1095).

16. In the present case the tuition fee and air fares were expenses incurred to enable the Taxpayer to read for a master degree. This was beneficial to both the Taxpayer and the university in that successful completion of that course might improve the Taxpayer's status and promotion prospects and also help the university to meet the needs in [the relevant subject area]. The expenses were therefore incurred for two purposes and would have to be apportioned provided the other tests were satisfied. However, we do not think that the expenses were necessarily incurred. They were not imposed by the Taxpayer's duties. They were not essential to the performance of his duties, even though the course may have been regarded as desirable by the Taxpayer and the university. He applied to the university for financial help and undertook the study of his own volition. He asked for tuition fee, air passage and paid leave and was granted only paid leave. (See a similar decision in BR 17/73, IRBRD, vol 1, 113.) Applying English principles, we have to answer question (b) in the negative.

17. The relevant English legislation in which the words 'wholly, exclusively and necessarily' appear is contained in the Income Tax Act 1952, Sch 9, para 7 which reads: 'If the holder of an office or employment of profit is necessarily obliged ... to expend money wholly, exclusively and necessarily in the performance of the said duties (that is, the duties of the office or employment), there may be deducted from the emoluments to be assessed the expenses so necessarily incurred and defrayed.' Therefore the words 'wholly, exclusively and necessarily' have been construed in the context of performance of the duties of the office or employment in question. On the other hand, the relevant Australian legislation contains no such words. Nevertheless, if by applying the Australian principles one is led to the conclusion that question (a) should be answered in the affirmative, should one go on to answer question (b)? We think that the answer must be yes, because the words 'wholly, exclusively and necessarily' do appear in our section 12(1)(a). If one applies English principles to answer question (b), the answer is no, as shown in paragraph 16 above. In BR 19/78, IRBRD, vol 1, 323, the Board refused to follow those principles on the grounds that the statutory provisions in the UK are distinguishable in material respects from the provisions of the Inland Revenue Ordinance, and that in Hong Kong what the taxpayer has to show is not that the holder of the office was necessarily obliged to incur the expense in the performance of the duties of his office but that it was incurred wholly, exclusively and necessarily in the production of his assessable income, which is a quite different matter. This means that the words 'the production of the assessable income' should be taken as they are, and not as if they were replaced by the words 'the performance of the duties of the office'. Applying this approach to the present case would, we think, produce the following results. The tuition fee and the air fares were incurred partly for the purpose of satisfying the Taxpayer's own desire for a master degree and partly and indirectly for the purpose of producing the assessable income in the sense that the course of study was part of the quid pro quo of the leave pay. Therefore an apportionment would be required. However, the

expenses were not necessarily incurred, for it cannot be said that the assessable income could not have been earned without incurring the expenses. The Taxpayer would have earned the same amount of income if he had not taken the course of study. Furthermore, we do not think that it is relevant to consider that successful completion of the course might result in higher income, because the test is whether the expenses are necessary for the production of the assessable income, and not whether they are necessary for the creation of a likelihood of higher income. In our view, question (b) would still be answered in the negative.

18. It follows therefore that this appeal is dismissed and that the assessment for the year of assessment 1986/87 is hereby confirmed.