INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D69/98

Salaries tax – whether transaction artificial or fictitious – whether contract of service or contract for services– section 61 of Inland Revenue Ordinance.

Panel: Christopher Chan Cheuk (chairman), Ho Kai Cheong and Roger Leung Wai Man.

Date of hearing: 7 May 1998.
Date of decision: 31 July 1998.

In about 1982, the taxpayer joined Company C and worked there. By the contract for artist staff dated 16 May 1988, the taxpayer agreed to serve as a programme host for 2 years from 1 May 1988 to 30 April 1990. By a letter dated 24 February 1989, the status of employment was changed from a contractual artist to permanent staff from 1 April 1989 (the 1988 Contracts). The taxpayer remained as a staff of Company C until 1 May 1992.

On 1 May 1992 Company C issued a letter to the sole proprietor of Company E (the Firm) carrying on business at the then home address of the taxpayer, in which the terms of employment were set out (the 1992 Contract). This was meant to supercede all the previous arrangement of employment that the taxpayer had with Company C, his employer.

On 1 May 1994, the parties entered into a new agreement (the 1994 Contract). It was expressly stated in the 1994 Contract that the sole proprietor of Company E was employed as a contractor.

The taxpayer gave the reason that changing the form of contract from the 1988 Contracts to the 1992 Contract and further to the 1994 Contract gave him freedom to perform his duty with Company C in the manner he considered absolute and also liberty to other outside works.

Held:

1. To decide whether the Firm was 'artificial' or 'fictitious' within the meaning of section 61 of the IRO, all the circumstances surrounding the transaction or arrangement have to be considered (Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner followed).

2. A commercially unrealistic transaction comes within the meaning of 'artificial' in section 61 (D44/92 considered).

3. The Board found that the 1992 Contract was aimed at securing the service of the taxpayer and not the Firm while the tenor of the 1994 Contract was also to secure the service of the taxpayer. In substance, the 1994 Contract is similar to a contract of personal service to be provided by the taxpayer but in the name of the Firm.

4. The Board found the freedom or liberty as contended by the taxpayer did not exist upon analysing the terms of the 1992 and the 1994 Contracts. The 1992 and the 1994 Contracts were contracts of service (Lee Ting Sang v Chung Chi-keung, Fall v Hitchen, Market Investigations Ltd v Minister of Social Security, Hall v Lorimer considered).

5. Examining all the facts, the Board found the interposition of the Firm is commercially unrealistic and artificial.

Appeal dismissed.

Cases referred to:

Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287
D44/92, IRBRD, vol 7, 324
Lee Ting Sang v Chung Chi-keung [1990] 2 WLR 1173
Fall v Hitchen 49 TC 433
Market Investigations Ltd v Minister of Social Security [1969] 2 QB 173
Hall v Lorimer [1994] STC 23

Tam Tai Pang for the Commissioner of Inland Revenue.
Kwan Chi Hung of Messrs T K Ho, Tax Representatives for the taxpayer.

Decision:

Appeal

1. This is an appeal by Mr A ('the Taxpayer') against the determination dated 9 October 1997 by the Commissioner of Inland Revenue in respect of the additional and second additional salaries tax assessment for the year of assessment 1992/93 and the salaries tax assessments for the years of assessment 1993/94 and 1994/95 raised on him.

Proceedings

2. The Taxpayer was represented by KWAN Chi-hung of T K Ho, FHKSA, authorised representative. The proceedings were conducted in Cantonese and the Taxpayer gave evidence on oath.

Facts of the Case

3. In the early eighties the Taxpayer returned from his study in Country B. In about 1982 he joined Company C and worked there.

4. The first agreement we find among the Appeal Bundle of documents was a contract for artist staff dated 16 May 1988 entered into between a certain Ms D on behalf of Company C and the Taxpayer whereby the Taxpayer agreed to serve as a programme host for a period of two years from the 1st day of May 1998 to the 30th day of April 1990. By a letter dated 24 February 1989 from the said Ms D to the Taxpayer it was confirmed that the status of employment was changed from a contractual artist to permanent staff with effect from 1 April 1989 (both the contract dated 1988 and the letter of 24 February 1989 are hereinafter collectively referred to as 'the 1988 Contracts'). It is not in dispute that the Taxpayer remained as a staff of Company C until 1 May 1992.

5. On 1 May 1992 the said Ms D as programme director on behalf of Company C issued a letter to the sole proprietor of Company E ('the Firm') carrying on business at the then home address of the Taxpayer, in which letter the terms of employment were set out ('1992 Contract'). This was meant to supercede all the previous arrangement of employment that the Taxpayer had with Company C, his employer.

6. On 1 May 1994, two years after the 1992 Contract, the parties entered into a new agreement consisting of 23 terms and conditions setting out the duties and obligations of the parties ('1994 Contract'). It was expressly stated in the 1994 Contract that the sole proprietor of Company E was employed as a contractor.

Issues

7. It is the Commissioner's decision that *'interposing the Firm was artificial or fictitious within the meaning of section 61'* and it is further decided that the income accrued under the 1992 Contract and the 1994 Contract was subject to salaries tax. The Taxpayer appealed against such decisions. The Board has to decide whether the interposition of the Firm was artificial or fictitious within the meaning of section 61 of the Inland Revenue Ordinance (the IRO) and whether the two Contracts were contract of service or contract for service.

Artificial or Fictitious

8. Section 61 of the IRO states: '*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'. This seems to give unlimited power to the assessor to disregard any transaction if he is of the opinion that the transaction is artificial or fictitious. In his determination, the Commissioner gave no reason why he considered the interposition of the Firm as artificial or fictitious. Neither did Mr TAM Tai-pang for the Revenue address on the point of law how and when this power would be invoked by the assessor.

9. According to our own research section 10(1) of the Income Tax Law 1954 in England had similar legislation: *'Where the commissioner 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 full effect has not in fact been given to any disposition, the commissioner may disregard any such transaction or disposition, and the persons concerned shall be assessable accordingly'*. English authority on the point at issue is of particular relevance. In Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287 at page 298 Lord Diplock commented on the word ***'artificia'*** : '"***Artificial***" *is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used.'* In that case the word ***'fictitious'*** is similarly construed and it has been decided that the word ***'artificial'*** has wider import than ***'fictitious'***. In other words we should not construe the two words in vacuum. We have to examine all the circumstances surrounding the transaction or arrangement before we come to any conclusion.

10. This decision has been followed by a number of Board of Review cases. In D44/92, IRBRD, vol. 7, 324 it has been held that *'a transaction was not artificial by reason of the fact … … that there was some element of tax planning or advice involved or that a taxpayer exercised a choice as to how the manage its affairs.'* However, it has been decided that *'a commercially unrealistic transaction'* came within the meaning of ***'artificial'*** in section 61. In the present case we have to consider whether the interposition of the Firm was commercially unrealistic and the entering into the 1992 and 1994 Contracts by the Firm as contracts for service was commercially unrealistic.

Contract for Service or Contract of Service

11. Both parties have cited a number of authorities for us to consider which include Lee Ting Sang v Chung Chi-keung [1990] 2 WLR 1173, Fall v Hitchen 49 TC 433, Market Investigations Ltd v Minister of Social Security [1969] 2 QB 173 and Hall v Lorimer [1994] STC 23. All these cases support one underlying principle that the fundamental test is whether a person engaged to perform certain services is performing those services as a person in business on his own account. We have to examine all the circumstances and evaluate them and draw our own conclusion from the evidence laid before us. As Lord Justice Nolan in Hall v Lorimer at page 29 agreeing with Mummery J in his decision where he says: *'In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by*

making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum of total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case.' Having this approach in mind it is not necessary for us to go into the factual details of each authority cited or to draw analogy with or distinction from the present case. What we have to do is to examine the factual situation of this case and draw our conclusions therefrom.

The contracts

12. It is never disputed that during the period before 1 May 1992 the Taxpayer was an employed staff of Company C and his income was subject to salaries tax. The 1988 Contracts were nothing but put the contractual relationship of the parties in writing. He completed the salaries return up to 30 April 1992. For the year of assessment 1992/93 the Taxpayer also filed another return, the profits tax return – persons other than corporations in which the Taxpayer claimed that he was trading as Company E. He considered that the status of employed staff had ceased and he had entered into a new contractual relationship with Company C.

13. The 1992 Contract was in the form of a letter written by Ms D on behalf of Company C and addressed to the sole proprietorship of Company E. It was accepted by the Taxpayer on behalf of the Firm. It consisted of two pages and began with the words: *'This serves to confirm our offer of employment to your company as programme producer …'* In Clause 2(a) it went on to say" *'Your company agrees to assign Mr A to work for on a full-time basis as programme producer & presenter'*. In Clause 4 (a) it was stated that the Firm would receive a monthly fee of $22,500 during the first year of the Contract and the amount would be increased by 10% per month in the second year. He was also entitled to a Chinese New Year year end bonus as well as a special incentive payment. As special terms in Clause 5 it was expressly stated:

> *'(a) Mr A is entitled to two weeks' leave after the completion of one year's service with our company.*
>
> *(b) Whilst under employment you are not allowed to work for any other broadcasting medium.'*

14. When we look at the 1992 Contract and try to construe all the terms as a whole, we find that the Contract looks more like a contract of service rather than contract for service. The contract was aimed at securing the service of the Taxpayer and not the Firm. The counter-argument is that the Taxpayer was a self-employed person who was at liberty to choose the way to conduct his own business. We do not intend to draw any conclusion at this stage and continue with our exercise of examining the other evidence of this case.

15. The next contract in the Appeal Bundle was the 1994 Contract which was very well written with terms usually found in contract for service. It was an agreement for a term

of three years from 1 May 1994. The Contract was entered into by the Firm as a contractor and it was so described in the Contract. The Firm was to provide consulting services (Clause 1) and to furnish sufficient full and part-time staff personnel for such services. The Firm had to indemnify Company C against any damages, costs or expenses incurred in connection with any wrongful acts of the Firm (Clause 9). The Firm was remunerated on yearly basis at the rate of $504,000 (Clause 10). The Firm had to bear all tax matters together with employee compensation and/or insurance.

16. It is very clear from the tenor of the 1994 Contract that its main purpose as the previous one was to secure the service of the ***'Key Person'***, that is, the Taxpayer himself (Clause 2). Under Clause 4 the Key Person was required to *diligently devote such time and best efforts as is reasonably required … and to attend work with the Company (Company C) for not less than 44 hours each week and shall use his best endeavour to comply with all instructions and request of the Company …'* By the same clause the Key Person was allowed to engage in other business activities but this power was badly limited by Clause 5 which states: *'Except with the previous approval of the Company, the Contractor and/or the Key Person shall not during the continuance of this Agreement be directly engaged or interested in any capacity in any trade profession or business whatsoever other than the business of the Company (Company C) irrespective as to whether or not the Contractor and/or the Key Person is remunerated or paid for such engagement'*. Clause 8 further limits the business of the Firm by stating: *'The Contractor and the Key Person shall not at any time during the term of this Agreement without the written consent of the Company either on his or in conjunction with or on behalf of any person or company perform in work for or make the consultancy services available to any other radio station(s) or broadcasting institution(s) within Hong Kong (including TV station(s), Cable TV and movie companies) irrespective as to whether or not the Company and/or the Key Person is remunerated, paid or obtained any benefit from such performance or service.'* Clause 15 provides that the 1994 Contract would be terminated upon the death of the Key Person or if the Key Person was incapacitated to render services for a total of 180 days over a period of 12 consecutive months. Company C also had the power to terminate the Agreement if the Key Person habitually failed to perform his duty or was convicted of a felony or a misdemeanour involving moral turpitude (Clause 16). Looking at these clauses we realise the importance that had been placed upon the Key Person, the Taxpayer himself. In substance the contract is similar to a contract of personal service to be provided by Taxpayer but in the name of the Firm.

17. The reason that the Taxpayer gave for changing the form of contract from the 1988 Contracts to the 1992 Contract and further to the 1994 Contract was that it gave him freedom to perform its duty with Company C in manner he considered absolute and also liberty to do other outside works. After analysing the terms of the two Contracts we do not find such flexibility. In the 1992 Contract the Taxpayer had to work on full-time basis and was required to work and report direct to programme director and also to produce programmes etc. as assigned. In the 1994 Contract he had to contribute not less than 44 hours of work each week to Company C and was not allowed to be engaged in any capacity in any trade, profession or business without consent. The so-called freedom or liberty did

not actually exist. According to the evidence given the nature of work assigned to the Taxpayer after entering into the 1992 Contract was similar to that before the 1992 Contract.

18. The Taxpayer also took up a number of external works during and before the relevant years of assessment as set out in the following table:

Year of Assessment	Employers	Work Performed	Amount $	Appeal Bundle
1990/91	Company 1	Casual Talent	2,500	page 25
1990/91	Company 2	Artist	1,000	page 26
1991/92	Company 3	Voice Over	10,000	page 28
1991/92	Company 2	V/O Recording	400	page 29
1992/93	Company 4	Voice Over	24,000	page 39
1993/94	Company 5	Author	37,000	page 38
1994/95	Company 4	Voice Over	26,000	page 36
1994/95	Company 6	Contractor	25,000	page 37

The fact emerged from this analysis is that there was no significant difference between the two periods, before and after the 1992 Contract.

19. The Taxpayer claimed that by entering into the 1992 and 1994 Contracts he lost all the fringe benefits of an employed staff and was not entitled to the provident fund arrangement. We consider these were commercial terms between the two parties and would be taken into consideration in negotiating the terms of the Contracts.

20. The Taxpayer also stated that he employed two staff to work for him. Both of them were closely related to him: Mr F was his brother and Ms G his sister-in-law. Each of them drew the same amount of salary. His brother was claimed to be his driver but evidence reveals that his brother had another full time job during certain part of the period claimed to be employed by the Taxpayer. We have great suspicion whether Mr F was truly employed by the Taxpayer. As to Ms G the Taxpayer could hardly describe her exact nature of work and according to his evidence she was to contact the outside world for him. This leads us to query why he needed such a person after the 1992 Contract. The amounts of income that he derived from the activities outside were $24,000, $63,693 and $51,000 for the years of assessment 1992/93, 1993/94 and 1994/95 respectively while the salaries he paid to Ms G were $45,000, $49,500 and $64,350 in the corresponding years. Economically it was not justified to employ such a person if the duty carried out by her was as described by him.

21. After examining the facts we stand back and look at the whole picture as painted by the evidence before us and we find that the interposition of the Firm is commercially unrealistic and is artificial. We also find that the 1992 and 1994 Contracts were contracts of service.

Decision

22. For reasons given above we decide that the Taxpayer has failed to discharge his duty of proof as required by section 68(4) of the IRO, and we dismiss the appeal. At the hearing the Board expressly invited Mr Kwan for the Taxpayer to address us on the question of allowances and he informed us that he would not dispute the amounts as set out the various assessments if we ruled against him. Because of this we uphold the different assessments as set out in section 2 the Commissioner's determination dated 9 October 1997.