Case No. D83/00

Salaries tax – additional assessment – interest free loan during study leave – deductions in respect of expenses incidental to study – sections 8(1), 8(2), 9(1), 11B, 11D, and 12(1) of the Inland Revenue Ordinance (' IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Barry J Buttifant and Dow Famulak.

Date of hearing: 19 September 2000.
Date of decision: 7 November 2000.

The taxpayer was previously an engineer of the Hong Kong Government. On 6 September 1987 the taxpayer commenced his no pay leave to undertake a Master of Engineering Course. According to a memo dated 13 January 1988 from the Secretary for the Civil Service, approval was given for the grant of an interest free loan to the taxpayer equal to his substantive pay (including increments due) with retrospective effect from the commencement date of his no-pay leave till the ending date of his first year' s study, payable on a monthly basis. The taxpayer was required to sign an undertaking and to provide a bond in respect of such loan, which he did. On the taxpayer' s completion of the bonding period of service, the repayment of the loan would be waived. Upon the granting of a waiver, such loan will be treated as a taxable income.

The taxpayer resumed duty on 4 September 1990 on completion of his courses. During his leave period, the Government made loans totalling $1,051,545 in favour of the taxpayer. This sum was not assessed to salaries tax in the years of receipt. On 14 July 1994 the taxpayer, having worked 1,410 days instead of the agreed period of 1,826 days, left the employment of the Government. This was before the five years' period as envisaged by the undertaking. A partial waiver in the amount of $811,981 was granted to the taxpayer and the taxpayer was asked to repay the Government the balance.

By a notice of additional assessment dated 22 January 1999, the taxpayer was additionally assessed for the year of assessment 1994/95 on the sum of $811,981, being ' that potion of the loan changed to your income as on 1 December 1995 when the repayment of it was formally waived' .

The taxpayer appealed and contended as follows:

1. In so far the sum of $811,981 constitutes assessable income the same should be regarded as part of his income for the period between 8 September 1987 (inception

date of the loan) and 4 September 1990 (date when the taxpayer resumed duty). If so, the relevant years of assessment were the years 1987 to 1991 and the Revenue is time barred in raising any assessment on 6 April 2000 (date of the additional notice of assessment).

2. In so far as the sum accrues to him on 17 October 1995 (date when the Secretary approved the partial waiver) that could not be regarded as income arising in respect of his employment with the Government in the year of assessment 1995/96 as he left the Government on 14 July 1994. It is impermissible for the Revenue to re-open his assessment as ' the sum had already annulled under the determination which is final and conclusive (section 70 refers).

3. In so far as his liability falls to be considered within the year of assessment 1994/95, no income accrued to him during that year. He was still indebted towards the Government and section 11D(b) of the IRO has no application.

4. In so far as the sum is chargeable to tax, he is entitled to claim deductions in respect of airfares, school fees, hostel charges, stationery and computers from such chargeable income.

Held:

1. It was expressly envisaged by the parties that had the agreement taken its full course, the loan would be converted into income at the point of waiver and the taxpayer would have to pay tax thereon. The waiver would have been in consideration of the services rendered by the taxpayer during the period of five years. The partial as opposed to the complete waiver was simply an attempt to relate the sum to be waived with the period of services actually rendered. Save for such apportionment, there was no change in the rationale behind the sum waived. The sum of $811,981 was income of the taxpayer accrued to him on 1 December 1995.

2. Prior to 1 December 1995, the sum of $811,981 was made up of advances in favour of the taxpayer. On 1 December 1995, the sum accrued in favour of the taxpayer in recognition of the services he rendered during the 1,410 days. At no time did the taxpayer receive any scholarship for the purpose of section 8(2)(g).

3. $811,980 was a payment made by the Government as employer to the taxpayer on 1 December 1995 after the taxpayer had ceased to derive income by virtue of his departure from Government services on 14 July 1994. Although the sum was ' paid' in favour of the taxpayer as a result of the waiver on 1 December 1995, section 11D(b)(ii) of the IRO deemed that sum to have accrued to the taxpayer on 14 July

1994. The taxpayer was therefore correctly assessed in respect of the year of assessment 1994/95.

4. The taxpayer did not satisfy the stringent conditions of section 12 of the IRO. He did not adduce any evidence to indicate that he was required by the Government to attend the courses. He was not performing the duties of an engineer when the alleged expenses were incurred.

Appeal dismissed.

Case referred to:

Clayton v Gothorp 47 TC 168

Fung Ka Leung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. The Taxpayer was previously an engineer of the Hong Kong Government [' the Government'].

2. On 6 September 1987, the Taxpayer commenced his no pay leave to undertake a Master of Engineering Course in a university in Country A. The leave period was extended for the Taxpayer to cover a Ph.D. Program in Engineering. It was expected that the Taxpayer would complete the doctoral program in November 1990.

3. According to a memo dated 13 January 1988 from the Secretary for the Civil Service [' the Secretary'] to the Director of Department B [' the Director'], approval was given for the grant of ' an interest free loan to the Taxpayer equal to his substantive pay (including increments due) with retrospective effect from the commencement date of his no-pay leave till the ending date of his first year' s study, payable on a monthly basis' . The Taxpayer was required to sign an undertaking and to provide a bond in respect of such loan. The Director was invited to note that ' On [the Taxpayer' s] completion of the bonding period of service, please approach the Civil Service Training Centre for a waiver of the repayment of the loan under CSR 1014(3). Upon the granting of a waiver, such loan will be treated as a taxable income and you are requested to notify the Commissioner of Inland Revenue subsequently about the change of the income tax.' A copy of this

memo was sent to the Taxpayer.

4. By an undertaking dated 10 October 1988 [' the Undertaking'], the Taxpayer undertook, inter alia, ' to continue in the service of the Government for a period of not less than five years following the end of training' . He further undertook to refund and repay immediately on demand to the Government ' all the monies paid to me or expended on my behalf in connection with the said course' should he fail to continue in the service of the Government for the said five years' period. This undertaking was secured by a bond furnished by the Taxpayer and his surety.

5. The Taxpayer resumed duty on 4 September 1990 on completion of his courses.

6. During his leave period, the Government made loans totalling $1,051,545 [' the Loan'] in favour of the Taxpayer. This sum was not assessed to salaries tax in the years of receipt.

7. On 14 July 1994, the Taxpayer left the employment of the Government. This was before the five years' period as envisaged by the Undertaking.

8. By a memo dated 17 October 1995, the Secretary informed the Director of Department C that a partial waiver was granted to the Taxpayer regarding his repayment of the Loan. The amount to be waived was computed in accordance with the following formula:

$1, 051,545 x 1,410 days/1,826 days = $811,981
(a) (b) (c)

(a) = The Loan

(b) = 4 September 1990 (date when the Taxpayer resumed duty) to 14 July 1994 (date when the Taxpayer left the Government)

(c) = 4 September 1990 to 3 September 1995 (expiry date of the five years period).

9. By letter dated 4 December 1995, the Taxpayer was asked to repay the Government $239,563.37 ($1,051,545 - $811,981). The basis of computation was made clear to the Taxpayer in this letter. The position was further explained to the Taxpayer by another letter dated 9 January 1996. The Taxpayer duly settled the amount of $239,564 on 5 February 1996.

10. By a notice of additional assessment dated 22 January 1999, the Taxpayer was additionally assessed for the year of assessment 1994/95 on the sum of $811,981. By letter dated 8 March 1999, the Revenue pointed out to the Taxpayer that the sum of $811,980 was ' that portion of the loan changed to your income as on 1 December 1995 when the repayment of it was formally waived' .

11. The Taxpayer appeals before us against that additional assessment. The Taxpayer contends as follows:

(a) In so far as the sum of $811,981 constitutes assessable income of the Taxpayer, the same should be regarded as part of his income for the period between 8 September 1987 (inception date of the loan) and 4 September 1990 (date when the Taxpayer resumed duty). If so, the relevant years of assessment are the years 1987 to 1991 and the Revenue is time barred in raising any assessment on 6 April 2000 (date of the additional notice of assessment). The Taxpayer argues that he was employed by the Government between 1987 and 1991 and the sum was income from his employment during that period albeit he did not render any service in return for the same.

(b) In so far as the sum accrues to him on 17 October 1995 (date when the Secretary approved the partial waiver), that could not be regarded as income arising in respect of his employment with the Government in the year of assessment 1995/96 as he left the Government on 14 July 1994 and there was no relevant employment for the year of assessment 1995/96. It is impermissible for the Revenue to re-open his assessment as ' the sum had already annulled under Determination which is final and conclusive (section 70 refers)' .

(c) In so far as his liability falls to be considered within the year of assessment 1994/95, no income accrued to him during that year. He was still indebted towards the Government and section 11D(b) of the IRO has no application.

(d) In so far as the sum is chargeable to tax, he is entitled to claim deductions in respect of air fares, school fees, hostel charges; books, stationery and computers from such chargeable income.

Relevant sections in the IRO

12. Section 8(1) of the IRO provides that:

' *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; ...'

13. Section 8(2) of the IRO provides:

‘ *In computing the income of any person for the purposes of subsection (1) there shall be excluded the following: -*

(a) ...

(b) ...

(c) ...

(d) ...

(e) ...

(f) ...

(g) *any amount arising from a scholarship, exhibition, bursary, or other similar educational endowment held by that person where he is receiving full time instruction at a university, college, school, or other similar educational establishment;’*

14. Section 9(1) of the IRO provides:

‘ 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 ...’*

15. Section 11B of the IRO provides:

‘ *The assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment.’*

16. Section 11D of the IRO provides:

‘ *For the purpose of section 11B –*

(a) ...

(b) *income accrues to a person when he becomes entitled to claim payment thereof:*

Provided that –

(i)

(ii) ... any payment made by an employer to a person after that person has ceased or been deemed to cease to derive income which, if it had been made on the last day of the period during which he derived income, would have been included in that person's assessable income for the year of assessment on which he ceased or is deemed to cease to derive income from that employment, shall be deemed to have accrued to that person on the last day of that employment.'

17. Section 12(1) of the IRO provides:

' 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 outgings 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.'

The case of Clayton v Gothorp

18. The Revenue placed heavy reliance on the decision of Plowan J in Clayton v Gothorp 47 TC 168. The issue there was whether the taxpayer was correctly assessed in respect of alleged taxable emoluments of his wife as a health visitor. The taxpayer' s wife entered into an agreement with the West Riding County Council whereby the Council agreed to make her a loan of £637 10s so as to enable her to take up a course of training at the Bradford Institute of Technology. The agreement provided that after the completion of the course of training, she would serve the County Council for a period of at least eighteen months. The agreement further provided that should she serve the County Council for the period so specified, then the agreement was to be void and of no effect at the termination of such period and no right of recovery was to exist against her in respect of the loan already made. The wife then terminated her employment with the County Council and commenced her course at the Institute. She was paid every month a sum equal to the salary which she would have drawn if her employment had not ceased. After completion of her training course, she served the County Council for a period of eighteen months. Three points were argued before Plowman J.

(a) The first point was whether the sum of £637 10s was a perquisite or profit from her employment. After an extensive review of the authorities, Plowman J summarised the law as follows (at page 178B) :

‘ *The points to note from these citations are, first, that in order to be a perquisite or profit the payment must be made with reference to the services which the employee renders and in the nature of a reward for those services, past, present of future. Secondly, the mere fact that the employee would not have received the payment but for the fact that he was an employee is not of itself enough to render him liable; it must be shown that the payment has been made in return for his services as an employee – or, as Lord Cohen put it, “The Court must be satisfied that the service agreement was the cause causans and not merely the causa sine qua non of the receipt of the profit”.’*

His Lordship went on (at page 179D) as follows:

‘ *The question therefore arises, when at the expiration of 18 months, namely on 15 July 1968, the £637 ceased to be repayable, what was it which turned the loan into an absolute payment? The consideration for the County Council’s making the loan in the first instance was the promise by Mrs Gothorp to follow the course of training and at its completion to serve the Country Council for a period of at least 18 mounts. But what turned the loan into an absolute payment was that 18 months service. Clearly, in my judgment, it was a reward for past services and, as such, an emolument arising from Mrs Gothorp’s employment. I think that the Commissioners made the mistake of asking themselves the wrong question. They considered the question whether Mrs Gothorp’s right not to repay the loan stemmed from the loan agreement or from her contract of service, as if the answer to that question concluded the matter. But in my opinion it does not, because the right not to repay the loan might well stem from the loan agreement and yet be taxable as a reward for services, and that in my opinion is the true position.’*

For these reasons, his Loadship held that the sum was perquiste or profit and taxable as such.

(b) The second point was whether the sum should be exempt as a ‘ scholarship’ in favour of the wife. Plowan J (at page 179H) rejected this claim. He said this:

‘ *I do not consider that the word “scholarship” is apt to cover a transaction of loan, which this was when the instalment was paid.’*

(c) The third point was whether the taxpayer there was correctly assessed in the

year 1967-68. His Lordship (at page 179I) thought it was.

> *' It was on 15 January 1968, when the 18 months' period expired, that a notional payment of £637 was made by the County Council to Mrs Gothorp by way of a release from her liability to repay that sum. That payment was therefore made in the tax year 1967-68.'*

19. We find the decision in Clayton v Gothorp helpful for the adjudication of this appeal.

Is the sum of $811,981 income of the Taxpayer

20. The facts of this case are almost identical with those in Clayton v Gothorp save in two respects. First, when the Government granted the Loan in favour of the Taxpayer in early January 1988, it was expressly contemplated by both parties that ' Upon the granting of a waiver, such loan will be treated as a taxable income ...' . It was therefore expressly envisaged by the parties that had the agreement taken its full course, the Loan would be converted into income at the point of waiver and the Taxpayer would have to pay tax thereon. There was no question of the income so converted being re-apportioned and treated as income accruing in each of the five years of services. Had the agreement taken its full course, the fiscal status of the sum of $1,051,545 was therefore left in no doubt. The waiver would have been in consideration of the services rendered by the Taxpayer during the period of five years. Given the express contemplation of the parties in this case, the position of the Revenue is stronger than the position of the tax inspector in Clayton v Gothorp had the agreement ran its normal course. Secondly, the agreement in this case did not run its normal course. The Taxpayer only worked 1,410 days instead of the agreed period of 1,826 days. Does this make any difference? We think not. According to a memo from the Director of the Civil Service Training and Development Institute to the Commissioner of Inland Revenue date 11 January 2000, ' it has been a common practice to recover from staff who have not completed the required post-training service a pro-rata amount of training cost according to the length of post-training service served.' ' ... written approval from SCS [the Secretary] was necessary in arranging the granting of partial waiver on the repayment of salary loan.' The partial as opposed to the complete waiver was simply an attempt to relate the sum to be waived with the period of services actually rendered. Save for such apportionment, there was no change in the rationale behind the sum waived. The sum was a loan till the point of waiver and the act of waiver converted the same into income. Such waiver was in consideration of the services rendered by the Taxpayer in those 1,410 days. We therefore agree with the Revenue that the sum of $811,981 was income of the Taxpayer. It accrued to the Taxpayer on 1 December 1995. It was never the contemplation of the parties that the sum so accrued would be re-apportioned amongst the 1,410 days.

Is the sum in question a ' scholarship' for the purpose of section 8(2)(g) of the IRO

21. The answer is likewise provided by Clayton v Gothorp, Prior to 1 December 1995, the sum of $811,981 was made up of advances in favour of the Taxpayer. On 1 December 1995,

$811,981 accrued in favour of the Taxpayer in recognition of the services he rendered during the 1,410 days. At no time did the Taxpayer receive any scholarship for the purpose of section 8(2)(g).

Was the Taxpayer correctly assessed in respect of the year of assessment 1994/95?

22. We are of the view that the Revenue is right in applying section 11D of the IRO. $811,980 was a payment made by the Government as employer to the Taxpayer on 1 December 1995 after the Taxpayer had ceased to derive income by virtue of his departure from Government services on 14 July 1994. Had the sum of $811,980 been made on 14 July 1994, that sum would have been included in the Taxpayer' s assessable income for the year of assessment 1994/95 which is the year of assessment on which the Taxpayer ceased to derive income from his employment with the Government. Although the sum was ' paid' in favour of the Taxpayer as a result of the waiver on 1 December 1995, section 11D(b)(ii) of the IRO deemed that sum to have accrued to the Taxpayer on 14 July 1994. The Taxpayer was therefore correctly assessed in respect of the year of assessment 1994/95.

Deduction of expenses

23. The Taxpayer does not satisfy the stringent conditions of section 12 of the IRO. He did not adduce any evidence before us to indicate that he was required by the Government to attend the courses in the University in Country A. He was not performing the duties of an engineer when the alleged expenses were incurred. We have no sympathy with the Taxpayer' s claim that he has difficulty in adducing relevant evidence as the assessment took him by surprise. As pointed out above, it was clearly envisaged by the parties that the full sum of $1,051,545 would attract tax after five years' services from the Taxpayer. Had there been any genuine claim for deduction of expenses, one would expect the Taxpayer to keep proper documentation given the conditions whereby the advances were first made.

24. For these reasons, we dismiss the Taxpayer' s appeal.