Case No. D9/08

Salaries tax – holiday benefit – exception - whether artificial or fictitious – sections 9(1)(a), 8(1) and 61 of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Wendy O Chan and D'ALMADA REMEDIOS Ng, Lisa Wei Min.

Date of hearing: 14 March 2008.
Date of decision: 23 April 2008.

The appellant submitted eight claim forms to his 2nd former employer who approved totally HK$20,048.93 as holiday benefit and deducted the sums from the appellant's monthly payroll for the year of assessment 1999/2000.

An enquiry was conducted into holiday and housing benefits provided by the 2nd former employer to its employees.

Additional assessment was raised on the appellant to assess his approved holiday benefit to salaries tax.

Failing the objection, the appellant appealed.

Held:

Section 9(1)(a) and section 8(1) IRO

1. The appellant's monthly cash package remained the same yet it comprised salary and holiday benefit. The amount of the monthly salary depended on the amount of holiday benefit approved by his 2nd employer.

2. The Board was satisfied that the sum of HK$20,048.93 was a holiday benefit within the meaning of exception to the then section 9(1)(a).

Section 61 of the IRO does not apply

3. There is no suggestion that the transaction was fictitious.

4. The overall position of having the total cash package remained the same does not by itself make the transaction 'artificial'.

4.1 It was commercially realistic and made business sense for the 2nd former employer (in recruiting and retaining employees) to provide holiday benefit to the appellant in the way it did;

4.2 It was commercially realistic and made business sense for the appellant (for a tax benefit with no reduction in the monthly cash package) to agree to the provision of holiday benefit by the 2nd employer.

Appeal allowed.

Cases referred to:

D21/00, IRBRD, vol 15, 309
Seramco Trustees v Income Tax Commissioner [1977] AC 287
Commissioner of Inland Revenue v D H Howe [1977] HKLR 436
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773

Taxpayer in person.
Yip Chi Yuen and Wong Ki Fong for the Commissioner of Inland Revenue.

Decision:

The Determination appealed against

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 13 December 2007 by which the additional salaries tax assessment for the year of assessment 1999/00 under charge number 9-2316135-00-9, dated 20 March 2006, showing additional net chargeable income of $20,048 with additional tax payable thereon of $3,408 was confirmed.

The issues

2. The issues in this case are:

(a) whether the sum of $20,048 ('the sum') was excluded by the then holiday benefit exceptions [1] to section 9(1)(a) of the Inland Revenue Ordinance, Chapter 112, from the charge to salaries tax under section 8(1); and

(b) if the answer to (a) is in the affirmative, whether section 61 applied and the sum should be included in the appellant's chargeable income.

The salient facts

3. The salient facts, as we find them, are as follows.

4. By a letter of appointment dated 5 August 1991, the appellant was employed by his 1st former employer as a marketing manager at a monthly salary of $24,000. That letter contained no provision on holiday benefit.

5. By consent, the appellant's employment by the 1st former employer was transferred to the 2nd former employer with effect from 1 February 1995.

6. By a letter dated 2 December 1998, the 2nd former employer informed the appellant that his monthly salary would be increased to $62,780 with effect from 1 January 1999. This letter also contained no provision on holiday benefit.

7. By an 'Acknowledgment of Compensation Package' dated 25 June 1999, the appellant informed the 2nd former employer of his 'wish to be considered for "Holiday Allowance" '.

8. The appellant submitted a 'Declaration – Holiday Allowance' dated 25 June 1999 to the 2nd former employer stating as follows:

> 'I declare that to the best of my knowledge of (*sic*) belief all the information contained in the claim for holiday allowance are true and correct and that I have attached valid receipts to substantiate the claim. I understand that the company has the right to disallow my claim if documentary supports are insufficient or unsatisfactory.'

9. The appellant submitted eight claim forms to the 2nd former employer for holiday benefit totalling $20,048.93.

Date	Amounts claimed	Amounts with no receipts[2]	Amounts approved[3]

[1] Section 9(1)(a)(i) – (iii). (i) – (iii) were repealed with effect from 1 April 2003

[2] According to the letter dated 17 January 2008 from the assessor

	$	$ (unless otherwise stated)	$
9 July 1999	4,370.10[4]	122 + 140	4,370.10
11 August 1999	2,297.14	82.5 + 35	5,119.00
11 August 1999	2,821.97	65 + 190 + 132 +66	
15 October 1999	3,684.78		3,684.80
22 December 1999	5,169.64		6,874.90
22 December 1999	332.92	85 + 40	
22 December 1999	968.77	144 + RMB75	
29 December 1999	403.61		
	20,048.93[5]		20,048.80

10. On each of these claim forms, the appellant instructed the 2nd former employer to make 'Payment direct to [him]' and stated that he preferred his total travel expenses 'to be deducted from [his] monthly payroll'.

11. Under cover of a letter dated 4 March 2008, the 2nd former employer's tax representatives gave the assessor the following breakdown of the appellant's remuneration:

	Base	Holiday benefit	Total
	$	$	$
April 1999	62,780.00		62,780.00
May 1999	62,780.00		62,780.00
June 1999	62,780.00		62,780.00
July 1999	58,409.90	4,370.10	62,780.00
August 1999	57,661.00	5,119.00	62,780.00
September 1999	62,780.00		62,780.00
October 1999	62,780.00		62,780.00
November 1999	59,095.20	3,684.80	62,780.00
December 1999	55,905.10	6,874.90	62,780.00

12. The appellant's employment by the 2nd former employer ceased on 31 December 1999.

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[3] See paragraph 11 below

[4] It is not clear from the copy documents whether the appellant claimed $4,370.10 or $4,370.15. Nothing turns on this difference.

[5] If the amount claimed on 9 July 1999 is $4,370.10, the total becomes $20,048.98

13. By his Tax Return – Individuals for the year of assessment 1999/2000, the appellant reported salary income of $637,048 from the 2nd former employer for the period from April to December 1999. The assessor raised on the appellant salaries tax assessment for the year of assessment 1999/2000 based on the income as reported by the appellant.

14. The assessor conducted an enquiry into holiday and housing benefits provided by the 2nd former employer to its employees.

15. As a result of the inquiry in respect of the appellant, the assessor formed the view the sum should be assessed to salaries tax and raised on the appellant the Additional Salaries Tax Assessment referred to in paragraph 1 above.

16. The appellant objected against the additional salaries tax assessment.

17. The objection failed and the appellant appealed to the Board.

Further findings of fact

18. Based on the facts as found by us in paragraphs 7 – 11 above, we make the following further findings of fact:

(a) The terms of the appellant's employment by the 2nd former employer were varied in or about June 1999 by the conduct of the appellant and the 2nd former employer to include a provision on holiday benefit.

(b) The total amount of the appellant's monthly cash package remained at $62,780.

(c) The 2nd former employer might approve holiday benefit up to 10% of the amount of the appellant's then monthly cash package, i.e. 10% of $62,780.

(d) The appellant's monthly cash package comprised salary and holiday benefit. The amount of the appellant's monthly salary depended on the amount (if any) of holiday benefit approved by the 2nd former employer. During the months when no holiday benefit had been approved, the appellant's monthly salary would remain at $62,780. If any holiday benefit had been approved in any month, the amount of the appellant's monthly salary for that month would be the difference between $62,780 and the amount approved as holiday benefit.

(e) The 2nd employer approved and paid to the appellant the following holiday benefit:

	Holiday benefit

	$
July 1999	4,370.10
August 1999	5,119.00
November 1999	3,684.80
December 1999	6,874.90

19. It would appear that the Deputy Commissioner agreed with our further finding (d). She applied section 61 on the basis that the appellant's 'monthly salary would fluctuate depending on how much he had spent on travel for that month or the month before'.

20. We accept the appellant's testimony that his monthly salary was paid into his bank account by autopay.

21. However, we do not accept his testimony that his travel benefit was paid to him by cheques and that the amounts credited into his account by autopay for those months were reduced accordingly. His testimony on this point is not supported by any contemporaneous document. It would be too cumbersome for the 2nd former employer to vary the instructions to the bank on a month to month basis and to issue a separate cheque for approved travel expenses. In our decision, it is more probable and we find as a fact that the monthly amounts transferred to the appellant's bank account remained at $62,780. Doing so satisfied the appellant's requests or instructions to make the holiday benefit payments direct to the appellant and at the same time to deduct the holiday benefit payments from his monthly payroll of $62,780.

Authorities on the holiday benefit exception

22. Section 8(1) provided that:

> *'(1) 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'.*

23. Section 9(1)(a) provided that:

> *'(1) 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, except-*

> *(i) the value of any holiday warrant or passage granted by an employer to an employee in so far as it is used for travel*[6]*;*
>
> *(ii) any allowance for the purchase of any such holiday warrant or passage in so far as it is expended for that purpose*[7]*; (Amended 1 of 1991 s. 3)*
>
> *(iii) any allowance paid by an employer to an employee for the transportation of the personal effects of the employee in connection with any journey on which a holiday warrant or passage referred to in subparagraph (i) or (ii) is used in so far as the allowance is expended for the transportation of the personal effects of the employee*[8]*; and (Amended 3 of 1949 s. 4; 9 of 1950 Schedule; 2 of 1971 s. 6; 40 of 1972 s. 2; 1 of 1991 s. 3)'*

24. We extract the following propositions from the Board's (Andrew Halkyard, Chua Guan Hock and Jiang Zhaodong) decision in D21/00, IRBRD, vol 15, 309:

> *(a) The statutory provisions on rental refund were very different from section 9(1)(a)(ii) and case law on rental refund was not helpful in holiday benefit cases.*
>
> *(b) The splitting and labelling of a payment was not conclusive.*
>
> *(c) The absence of employer control over the way the holiday allowances were expended was not of itself conclusive.*
>
> *(d) Holiday benefit was not by itself exempted from salaries tax.*
>
> *(e) But, to the extent that an employee did incur holiday travel expense not exceeding the amount of the holiday allowances specifically granted to him, this was exempted from salaries tax.*

25. Mr Yip Chi-yuen told us that he accepted that D21/00 was correctly decided, both in principle and on the facts of that case.

Whether within holiday benefit exception

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[6] Repealed with effect from 1 April 2003
[7] Repealed with effect from 1 April 2003
[8] Repealed with effect from 1 April 2003

26. The items in paragraph 18(e) above were approved and paid to the appellant as holiday benefit.

27. The appellant testified that the sum had been expended for holiday purposes. The appellant's claims for holiday benefit, with the exception of the items under the 3rd column of the table in paragraph 9 above, were supported by receipts. The items not supported by receipts were items where no receipt would (normally) be issued. We accept the appellant's testimony that all the items, including those not supported by receipts, had been expended.

28. Mr Yip Chi-yuen contended that some expenses were not supported by receipts as required under the written terms of the 2nd former employer's benefit scheme and some were expenses excluded under the terms. We assume in favour of the Revenue that the copy scheme produced was the same as the scheme applicable at the relevant times. However, we conclude that the terms relied on by the Revenue are irrelevant because upon submission of the eight claim forms by the appellant, the 2nd former employer chose to approve the expenses. Effectively, this was a variation of those terms in favour of the appellant.

29. The appellant has satisfied us on a balance of probability that the sum was a holiday benefit within the meaning of the then exception to section 9(1)(a).

Authorities on section 61

30. Section 61 provides that:

> *'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.'*

31. We remind ourselves of the observations made by Lord Diplock, delivering the advice of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at pages 297-8 in relation to section 10(1) of the Jamaican Income Tax Law 1954, in similar terms to our section 61:

> *'It is only when the method used for dividend stripping involves a transaction which can properly be described as "artificial" or "fictitious" that it comes within the ambit of section 10 (1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*

> *"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 common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.'*

32. Lord Diplock considered whether the impugned transaction was 'unrealistic from a business point of view' (at page 294).

33. In Commissioner of Inland Revenue v D H Howe [1977] HKLR 436 at 441 [(1977) 1 HKTC 936 at page 952], Cons J (as he then was) considered whether the impugned transaction was 'commercially unrealistic':

> *'What then are the arrangements and the circumstances in which they were made and carried out that I must examine in order to see whether or not they are artificial? Simply they are these. By two separate agreements the taxpayer effectively transferred all his existing and future earnings as an author to a limited company. The consideration in each case was valuable in the technical sense but by no stretch of the imagination otherwise. If that were all, the agreements would have been, as counsel for the Commissioner suggests, in the words of their Lordships (p. 294) quite "unrealistic from a business point of view". But there is one other circumstance to consider. The limited company which is the beneficiary of the taxpayer's apparent generosity is controlled by the taxpayer himself. That was a fact found by the Board of Review and I assume it to mean that the taxpayer holds all or substantially all of the shares therein. In this situation it does not necessarily follow that the transactions are commercially unrealistic. The overall position remains the same. What the taxpayer loses on the roundabouts he makes up on the swings. Looked at purely from the aspect of gross income the transactions seem unnecessary and unproductive. But the taxpayer may well have other matters in mind. I find*

> *nothing on the face of things that makes the agreements artificial in the way that their Lordships approached the Seramco situation. To my mind they are artificial only in the sense e.g. that a limited company is artificial. It is not the product of nature, it is the outcome of man's inventive mind. I am satisfied that the Board of Review came to a correct conclusion on this question.'*

34. In Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKRLD 773, CA, at paragraph 41, Woo JA said whether a commercially unrealistic transaction must necessarily be regarded as being 'artificial' depends on the circumstances of each particular case and that commercial realism can be one of the considerations for deciding artificiality:

> *'The term "commercially unrealistic" appears in CIR v Howe (1977) 1 HKTC 936 at p.952 in the sense of "unrealistic from a business point of view". We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree with the submission of Mr Cooney, however, that commercial realism or otherwise can be one of the considerations for deciding artificiality. In the present case, the Board found as a fact that there was no "commercial reality in the transaction" and that there "simply was no commercial sense in the transaction"; thus it was open to the Board to reach the conclusion that the transaction was artificial under s.61.'*

35. At paragraphs 60 – 61, Woo JA held that once the interposition of the service company was disregarded, it was open to the revenue to assess the taxpayer on the basis as if the remuneration paid by the employer to the taxpayer's service company had been received by the taxpayer as an employee of the employer:

> *'60 The relevant word used in s.61 is "disregard" and not "annihilate", "avoid" or "annul". Where a transaction is found by the assessor to contravene s.61, he may "disregard" it and "the person concerned shall be assessable accordingly". The "person concerned", as can be seen in the earlier part of the section, is the person "the amount of tax payable by" whom is reduced or would be reduced by the transaction. We think the meaning of "accordingly" is clear enough, which is the situation where the transaction is disregarded. The taxpayer in the present case is the person whose tax was reduced by intervention of the contracts and the interposition of First-Rate. When the transaction was disregarded by the assessor pursuant to s.61, the real nature of the remuneration that had been paid by Sun Ling to First-Rate was exposed. The remuneration was paid for the provision of the services that the taxpayer, and he alone to the exclusion of First-Rate and anyone else, made to Sun Ling, and as such, is assessable as his own income. Indeed,*

> *the transaction apart, the real relationship between Sun Ling and the taxpayer in the circumstances of this case has been well demonstrated to be that between employer and employee. It is unnecessary to deem the remuneration as the taxpayer's income. It suffices where the transaction has been disregarded to look at the reality of the remuneration and the relationship. Mr Cooney draws our attention to passages in the judgments of the judges in the majority in Bunting v Commission of Taxation (1989) 20 ATR 1579 at p.1585 per Beaumont J and at p.1590 per Gummow J. The judges were considering what the Revenue was entitled to do where arrangements that offended s.260 of the Income Tax Assessment Act had been annihilated. They held that "the exercise is necessarily a hypothetical one" and the fact was exposed that the income had been earned by the appellant's own exertions and that the Revenue was entitled to "treat the taxpayer as having derived the income which was the return from his own activities." Support can also be found in Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287 at p.300 where a similar method was employed by Lord Diplock.*
>
> *61. Once the transaction in the present case was disregarded by the Revenue, it was open to the Revenue to assess the taxpayer on the basis as if the remuneration paid by Sun Ling to First-Rate had been received by him as an employee of Sun Ling.'*

36. Mr Yip Chi-yuen did not cite the Cheung Wah Keung case although he said he had 'heard of it before'.

37. The Cheung Wah Keung case dealt with the relevance of commercial reality in considering whether a transaction is 'artificial' within the meaning of section 61. This Court of Appeal judgment is binding on the Board.

Application of section 61

38. Section 61 applies to transactions and dispositions. In respect of transactions, one must first identify the transaction. The second step is to consider whether the transaction reduces or would reduce the amount of tax payable by any person. If the answer is in the affirmative, one must consider whether the transaction is 'artificial' or 'fictitious'.

39. Once a transaction is caught by section 61, the transaction may be disregarded and the person concerned shall be assessed accordingly.

40. According to the Deputy Commissioner, the relevant transaction in this case is the classification of the sum as holiday benefit/passage.

41. This case went beyond mere classification. The terms of the appellant's employment were varied by mutual consent. The appellant had to, and did, submit claims, backed up by receipts, to claim holiday benefit. The 2nd former employer had to, and did, process and decide on the amount (if any) of holiday benefit.

42. The next question is whether the transaction reduces or would reduce the amount of tax payable by the appellant.

43. As we have concluded that the sum was a holiday benefit within the meaning of the exception to section 9(1)(a), the tax reduction requirement is satisfied.

44. We turn now to the question whether the transaction was artificial.

45. The Deputy Commissioner was of the view that:

> '... classification of the Sum as holiday benefit/transaction is an artificial transaction under section 61 of the Ordinance. It is commercially unrealistic that an employee's monthly salary would fluctuate depending on how much he had spent on travel for that month or the month before. It follows from section 61 of the Ordinance that such classification should be disregarded and the Taxpayer should be assessed on the salary in its entirety.'

46. Mr Yip Chi-yuen submitted that:

> 'In any event, it is commercially unrealistic that the Appellant's monthly salary would fluctuate depending on whether how much he had spent on travel for that month or the month before. As such, I submit that classification of the Sum as holiday benefit is an artificial transaction and it follows that such classification should be disregarded and the Appellant should be assessed on the salary in its entirety.'

47. In reply to a question from the Board, Mr Yip Chi-yuen said that the transaction was artificial 'because the arrangement was to convert what was in fact salary and taxable income into non-taxable holiday allowance'. We disagree. He is in effect saying that any transaction which reduces tax payable is 'artificial'. This means that the 'artificial' requirement is otiose.

48. Mr Yip Chi-yuen went on to argue that there was 'no commercial sense for the transaction'. We asked him to identify the person from whose point of view the transaction had no commercial sense. He did not answer our question.

49. Mr Yip Chi-yuen went on to say that it was 'not what would normally be happening in the commercial world. Normally, a taxpayer or employee should have a fixed amount of salary'.

50. It is not unusual for an employee to have his salary split into two components, a fixed pay component and a variable pay component. It is also not unusual for an employee, e.g. those involved in sales and marketing, to have a variable amount of salary depending on his meeting various sales targets. In any event, to categorise all transactions which are not 'normal' as 'artificial' goes too far.

51. Mr Yip Chi-yuen concluded his submission by saying that:

> 'My view is that if you deduct salary on the one hand and pay it back on the other hand, it is commercially unrealistic.'

52. That the 'overall position remains the same' does not necessarily mean that the transaction is artificial, see the Howe case at page 592.

53. With respect to the Deputy Commissioner and with some diffidence because the issue has not been properly or fully argued before us, we do not think the transaction was artificial or commercially unrealistic. There is no suggestion that the transaction was fictitious.

54. The transaction itself must be artificial.

55. The holiday benefit scheme was at no extra cost to the 2nd former employer. The pay package remained the same. There would be some extra work for the human resources department to process and approve claims. The balancing factor is that if the scheme was effective, a pay package which reduced or would reduce an employee's tax liability could help the employer in recruiting and retaining employees. In our view, it was commercially realistic and made business sense for the 2nd former employer to provide holiday benefit to the appellant in the way it did.

56. From the appellant's point of view, there would be no reduction in the monthly cash package. If the scheme worked, there would be a tax benefit to him. In our view, it was commercially realistic and made business sense for the appellant to agree to the provision of holiday benefit by the 2nd former employer.

57. The overall position, i.e. the total cash package, remains the same. That does not by itself make the transaction 'artificial'.

58. There is no reason why the parties would not have agreed to the holiday benefit provision in the absence of a tax benefit. Neither the appellant nor the 2nd former employer had anything to lose by reason of the holiday benefit provision.

59. We conclude that the artificial or fictitious requirement is not satisfied. Section 61 does not apply.

Conclusion

60. The sum was exempted from salaries tax under the holiday benefit exceptions to section 9(1)(a) and section 61 did not apply.

61. The appellant has discharged the onus under section 68(4) of proving that the assessment appealed against is excessive and incorrect.

62. We allow the appeal and annul the additional salaries tax assessment for the year of assessment 1999/00 under charge number 9-2316135-00-9, dated 20 March 2006, showing additional net chargeable income of $20,048 with additional tax payable thereon of $3,408.