Case No. D93/01

Salaries tax – housing allowance – whether income or rent refunds.

Panel: Ronny Wong Fook Hum SC (chairman), Melville Thomas Charles Boase and Gregory Robert Scott Crichton.

Date of hearing: 14 August 2001.
Date of decision: 31 October 2001.

The appellant owned a flat. He was given payments as housing allowance by his employers for renting his flat.

He claimed that there were tenancy agreements between him and his employers and the payments to him were rent refunds and thus being not assessable to salaries tax.

Held:

The Board found no such tenancy agreements existed in reality and the appellant failed to prove that the payments were rent refunds.

Appeal dismissed.

Cases referred to:

D8/82, IRBRD, vol 2, 8
D19/95, IRBRD, vol 10, 157
D33/97, IRBRD, vol 12, 228
D77/99, IRBRD, vol 14, 528

Ngan Man Kuen for the Commissioner of Inland Revenue.

Taxpayer represented by his tax representative.

Decision:

The background

1. By letter dated 29 May 1992, Company A offered the Appellant employment as a 'senior accounts clerk' with salary at $8,000 per month. It was a term of that employment that the Appellant be entitled to participate in Company A's provident fund scheme. Under that scheme, the Appellant was required to contribute 5% of his monthly basic salary as employee's contribution to the scheme.

2. By an agreement dated 7 November 1995, the Appellant purchased a flat at Housing Estate B ('the Flat') for $1,535,000. The purchase was financed in part by a home mortgage loan of $900,000 extended by Bank C in favour of the Appellant. It was a term of that loan that the sum advanced was 'to finance purchase of property for self-use only'. Letting of the Flat was not permissible without the prior consent of Bank C. At no time did the Appellant seek any consent from Bank C in that respect.

3. By an alleged tenancy agreement dated 18 December 1995 ('the Company A Agreement'), the Appellant let the Flat to Company A for a term of two years with effect from 1 January 1996 to 31 December 1997 with rental at $8,000 per month. At no time was the Company A Agreement stamped.

4. Company A subsequently changed its name to Company D. By letter dated 27 February 1997, Company D informed the Appellant of his promotion to the position of finance manager with effect from 1 January 1997 and that his new salary was $22,000 per month.

5. By letter dated 15 February 1997, the Appellant applied to Bank C for lowering of the interest rate under his home mortgage loan. He informed Bank C that 'Currently my basic monthly income is $20,000 before adjustment in February 1997'.

6. The Appellant terminated his employment with Company D on 30 June 1997. According to Company D's final payment computations dated 17 June 1997 and 11 August 1997, the salary of the Appellant was $22,000 per month. His entitlements were computed on that basis.

7. By notice under section 52(5) of the Inland Revenue Ordinance ('IRO'), Company D informed the Revenue that they provided quarters to the Appellant at the Flat during the period between April 1997 and June 1997 and the amount of rent paid to the landlord during that period was $27,000.

8. By letter dated 6 May 1997, Company E offered the Appellant employment as accounts manager with starting salary at $25,000 per month. The Appellant's salary would be revised after successful completion of a three months' probationary period.

9. By letter dated 1 July 1997, Company E sought to amend the Appellant's employment contract as follows:

> ' (i) monthly salary will be $15,000.
>
> (ii) the company will provide you free accommodation, subject to a maximum rent of $10,000.
>
> The above amendments will be effected from 1 July 1997.'

10. According to the employer's return submitted by Company E dated 30 April 1998, the income of the Appellant for the period between 10 June 1997 and 31 March 1998 amounted to $169,401. Company E allegedly provided quarters to the Appellant in the Flat during the period between July 1997 and March 1998. $90,000 was allegedly paid to the landlord by the Appellant and the same was refunded to the Appellant by Company E.

11. The issue before us is whether the sum of $27,000 paid by Company D and the sum of $90,000 paid by Company E were part of the Appellant's income or whether those sums were rent refunds and hence not assessable to salaries tax.

Pre-hearing correspondence between the parties

12. Correspondence between Company E and the Revenue

(a) By letter dated 27 November 1998, Company E informed the Revenue that there was no tenancy agreement between the landlord and Company E. Debit notes were issued by the landlord to Company E on a monthly basis and rental receipts were issued after payment. Company E submitted to the Revenue a bundle of such debit notes and receipts for the period between July 1997 and March 1998. The debit notes were for rental (inclusive of rates, government rent, building management fee and utilities) at $10,000 per month. The receipts acknowledged payments on the first of each month.

(b) By letter dated 31 October 1999, Company E informed the Revenue that 'Employees with assistant manager grade or above are eligible for housing benefits. Eligible staff are encouraged to rent the quarters themselves and ask for reimbursement in order to minimise the administrative workload'. The

Revenue was further informed that 'Rental was reimbursed together with [the Appellant's] salary in one lump sum payment at end of each month to [the Appellant's] bank account'.

13. Correspondence between the Appellant and the Revenue

(a) By letter dated 23 December 2000, the Appellant explained to the Revenue that:

(i) There was a change of rental for the tenancy between Company D and the Appellant in January 1998. The amount was revised from $8,000 to $9,000. Such change was effected orally between the parties.

(ii) The Company A Agreement 'was prepared for internal documentation purpose only. Both landlord and tenant were confident that there would not be any dispute regarding the rental of the property and therefore stamping of the tenancy agreement was considered unnecessary'.

(iii) He produced sample receipts issued to Company D. He acknowledged that 'The rental refund and salary were paid in one lumsum [*sic*] monthly'.

(b) In letter dated 27 March 2000, the Appellant explained his relationship with Company E as follows:

' Due to the fact of the admittance of the relation between all parties, namely the employer, the employee, the landlord and the tenant, the non-existence of tenancy agreement was no longer a crucial factor in determining such relationship. Such arrangement was implemented without making too much unnecessary work such as the signing of tenancy agreement between the employer and the landlord, depositing salary and rent into two separate bank accounts of the same name. Instead of the above, the employer was trying to implement more control such as the issue of rental receipts, and request the employee to declare rental income to IRD'.

The hearing before us

14. Mr F appeared on behalf of the Appellant. He did not call any evidence. He submitted that the subsistence of the landlord-and-tenant relationship between his client and Company D/Company E cannot be denied. He further submitted that all the documents relied upon by the Appellant were not prepared after the events. All the documents were contemporaneous as part of the Appellant's tax planning exercise. He admitted that the Appellant had failed to inform Bank C about the grant of the tenancy and explained that it was attributable to the Appellant's oversight.

15. Miss Ngan for the Revenue submitted that:

(a) There was no landlord-and-tenant relationship between the Appellant and his employers regarding the Flat. The sums paid by his employers were not rent for renting the Flat.

(b) The Appellant did not incur any rental expenses in respect of the Flat. The sums received from his employers could not be refund of rent paid.

(c) The sums paid by Company D and Company E were part and parcel of the Appellant's remuneration package. The mere labelling of a part of the payments as rent refund pursuant to an alleged 'housing arrangement' would not render that part as exempt income.

(d) The transaction of 'letting' of the Flat by the Appellant to his employers or to himself is artificial or fictitious within the meaning of section 61 of the IRO and should be disregarded.

The law on housing allowance versus rental refund

16. In D8/82, IRBRD, vol 2, 8, the Board of Review pointed out that:

' To label a payment in addition to salary as a "housing allowance" or to split a taxpayer's remuneration into two parts and call one part a "housing allowance" would not necessarily render that portion so described as exempt income. It is quite capable of falling into the category of a perquisite or allowance so as to be taxable by virtue of section 9(1) of the Inland Revenue Ordinance.

If a place of residence is not provided by the employer..., the taxpayer must be able to show that the sum he has received and claimed by him as a "housing allowance" is a rental refund, either wholly or in part, which would entitle him to such tax relief as mentioned in section 9(1A)(a), (b) or (c) of the Ordinance.'

17. In D19/95, IRBRD, vol 10, 157, the Board of Review considered the evidence and came to the conclusion that the sums in dispute were cash allowance which were placed generally at the disposal of the taxpayer by the employer. The employer was not concerned whether the payments were actually spent by the taxpayer on housing. The Board of Review pointed out that the fact that some of the payments was used by the taxpayer to occupy a hotel room and later to rent a flat was of no assistance to him as 'This cannot of itself convert a payment into a refund'. The Board concluded that the payments made to the taxpayer were simply allowances which were subject to tax.

18. In D33/97, IRBRD, vol 12, 228, the taxpayer claimed that sums paid by his employer to him were rental refunds. In support of this contention, he produced unstamped tenancy agreements said to evidence tenancies over premises owned by his parents and by his mother and the taxpayer himself. The Board of Review found there was no tenancy as the parties had no intention to enter into legal relations. The Board went on to point out that:

> '*A "refund" of rent connotes a repayment or reimbursement, not mere payment ... This means, in the typical case, that sufficient control must, as a matter of fact (and not just in theory), be exercised by the employer over the payment so that the allowance is effectively a refund of rent and not just an additional emolument to be spent in any way that an employee may desire. Where ... an employee has acted in a way such that the employer's system of control cannot operate in the manner for which it was designed (for example, by the employee's failure to submit to the employer a lease agreement or rental receipts for verification), it ill-behoves the employee to then argue that a payment received from the employer must be a refund simply because rent was, in the event, paid by the employee. Conversely, if no system of employer control exists to verify that a payment made to an employee was a refund of rent, this is simply a cash allowance. In neither case would the payment in law amount to a rental refund for salaries tax purposes.*'

The law in relation to the application of section 61 of the IRO

19. Section 61 of the IRO 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.*'

20. In D77/99, IRBRD, vol 14, 528, the Board took the view that:

(a) The words 'artificial' and 'fictitious' are to be given the ordinary meaning.

(b) 'Artificial' is wider than 'fictitious'. According to the Shorter Oxford Dictionary, 'artificial' means not natural, a substitute for what is natural or real, feigned, fictitious. 'Fictitious' means artificial, counterfeit, sham, not genuine, feigned, assumed, not real, imaginary, of the nature of fiction.

(c) All the circumstances of the particular transaction have to be examined if it is artificial or fictitious.

(d) A transaction is not artificial by reason of the fact that it is between related parties.

(e) A transaction is not artificial by reason of the fact that it is intended for tax planning purpose.

(f) However if there is no commercial sense for the transaction and no purpose for the transaction other than for tax benefit, it may well fit the expression 'artificial'.

Our decision

21. By virtue of section 15(1) of the Stamp Duty Ordinance (Chapter 117), we refuse to receive in evidence the Company A Agreement. The Appellant would have to prove the subsistence of any tenancy between Company D and himself by other evidence.

22. The evidence before us does not support the existence of any such tenancy. When Company D wrote to the Appellant on 27 February 1997 in relation to his new status as finance manager, Company D referred expressly to his new salary at $22,000 per month. His monthly contribution towards Company D's provident fund scheme was computed at 5% of $22,000. Upon termination of his employment on 30 June 1997, he received a pro-rata double pay of $11,000 which was calculated on the basis that his monthly salary was $22,000 and not $13,000. The Appellant gave no notice to Bank C pertaining to his alleged grant of tenancy in favour of Company D. We place no weight on the rent receipts tendered on behalf of the Appellant. Those receipts do not reflect the reality. In relation to the receipts dated 1 April 1997, 1 May 1997 and 1 June 1997, the purported rental payments were only credited into the Appellant's account by autopay on 26 April 1997, 29 May 1997 and 25 June 1997.

23. The Appellant declared in his tax return that the sum of $27,000 was paid by him to the landlord and he obtained a refund of the same from Company D. Quite apart from the inconsistency between this case and his case on the basis of a contractual relationship between Company D and himself, there is no evidence to suggest the grant of any tenancy to himself. Such a suggestion is divorced from reality.

24. For these reasons, we hold that the Appellant failed to discharge the onus resting on him in relation to the payments from Company D.

25. As far as the payments from Company E are concerned, the Appellant claimed in his notice of appeal that Company E made a mistake in its employer's return and the sum of $90,000 should be more appropriately described as 'rent paid to the landlord'. This case is contrary to Company E's intimation to the Revenue in their letter dated 27 November 1998 that 'No tenancy

agreement was signed between the landlord and the company' and in their letter dated 31 October 1999 that '... the tenant and landlord are both [the Appellant]'. The Appellant himself admitted in his letter to the Revenue dated 5 June 1999 that 'Company E and I decided to adopt the reimbursement basis so as to simplify the arrangement by not signing any tenancy agreement between [Company E] and the landlord.' Given these admissions, we attach no weight to the alleged debit notes and official receipts which the Appellant submitted for our consideration. We find that there was no tenancy relationship between Company E and the Appellant.

26. Company E declared in its employer's return that a place of residence was provided to the Appellant by way of refund of rent. There is no evidence before us to indicate that the Appellant had ever, in the alleged capacity as tenant of the Flat, paid rent to himself as the landlord of the Flat. There is also no evidence to indicate that Company E exercised any control in relation to refunds for his alleged tenancy. They had never inspected any tenancy agreement which allegedly formed the basis of any refund.

27. As indicated by the offer letter dated 6 May 1997, the Appellant was employed by Company E at a salary of $25,000 per month. The purported amendment on 1 July 1997 was a crude effort to split his remuneration. The Board had long stated in D8/82 that the choice of labels by the parties does not entail automatic exemption.

28. The Appellant has likewise failed to discharge the onus resting on him in relation to the payments from Company E.

29. For these reasons, we dismiss the Appellant's appeal.