(b) The individual personally carries out the same or similar services for persons other than any person for whom services are required to be carried out under the agreement (sec 9A(3)(b)). This caters for genuine contractors who normally have more than one client (DIPN No 25, para 22).

(c) The performance of services by the individual is not subject to control or supervision, which would commonly be exercised by an employer, by any person other than the corporation or trustee concerned referred to in sec 9A(1)(a), (b) or (c) (sec 9A(3)(c)). Any control or supervision exercised by the service company may be disregarded. As a matter of practice, the Department also will not take into account supervision or control which can be attributed to statutory requirements and is not dependent on the existence of an employer/employee relationship (DIPN No 25, para 24).

(d) The remuneration is not paid or credited periodically or calculated on a basis commonly used under a contract of employment (sec 9A(3)(d)). Regard must be had to the basis for calculating the payments. For contractor situations, payments are generally based on an agreed sum for specified work under a contract. Employment payments are usually in respect of time worked, or position occupied, and made on a regular basis (DIPN No 25, para 26).

(e) The person paying the remuneration does not have the right to cause the individual to cease performing services in the way that an employer has the right to dismiss an employee under a contract of employment (sec 9A(3)(e)). An employee's services can generally be terminated by providing notice or meeting other requirements under an award or statute. An independent contractor's contract is usually discharged by performance or it may specify default situations under which it can be terminated (DIPN No 25, para 27).

(f) The relevant person is not held out to the public as an officer or employee of the person paying the remuneration (sec 9A(3)(f)). "Held out to the public" is not defined in the Ordinance and therefore must be given its ordinary meaning. Members of the public may be led to believe that an individual is an officer or employee of the relevant person, for example, through material included in trade or professional directories, journals or other publications, the issue of name cards, statements at public functions, information contained in press releases, etc (DIPN No 25, para 28).

Since all of the above conditions must be fulfilled in order for a service company or trust arrangement to escape the effect of sec 9A(1), it is expected that sec 9A(3) exemption will rarely apply. It is unlikely that even a taxpayer who genuinely is not an employee would be able to fulfil the stringent requirements of this provision.

The taxpayer in *Case* M12 (2003) HKRC ¶80-877 (*D108/01*) was an actor who incorporated a service company for the purpose of contracting out the actor's services to a TV broadcasting company (the TV company) in Hong Kong. However, on application to the Commissioner in 1995 and in 1997, the Commissioner rejected the arrangement and took the view that the taxpayer was liable to salaries tax under sec 9A(1) on the payments from the TV company. The taxpayer objected and appealed to the Board of Review. The taxpayer argued that sec 9A(3) was satisfied as some paragraphs had been satisfied.

The Board of Review held that sec 9A(1) shall not apply only where all the paragraphs in sec 9A(3) are satisfied. In this case, that some paragraphs of sec 9A(3) were satisfied did not assist the taxpayer. All the paragraphs must be satisfied in order for sec 9A(1) not to apply. The taxpayer worked exclusively for the TV company and was bound to follow the directions of the TV company's production executives. His performance was controlled or subject to controls commonly exercised by an employer over an employee. It was clear from the 1995 and 1997 service deeds that the TV company had contracted for the exclusive personal services of the taxpayer and that the interposition of the service company between the taxpayer and the service company was artificial. The onus of proving the assessment to be incorrect was on the taxpayer and this onus had not been discharged.

See also *Case* R6 (2008) HKRC ¶81-224 (*D5/07*); *Case* Q28 (2007) HKRC ¶81-214 (*D78/06*); *Case* P19 (2006) HKRC ¶81-171 (*D13/06*) and *Case* N53 (2004) HKRC ¶81-029 (*D62/03*).

In *Case* H45 (1998) HKRC ¶80-553 (*D103/97*), the consultancy agreement between the employer and the taxpayer's own company was found to be artificial and fictitious. The consultancy fees were held to be remuneration paid to the taxpayer. The arrangements were disregarded and the taxpayer was assessed to salaries tax on the payments received by his own company.

Where the Commissioner is satisfied that no employment exists

An individual performing services will not be deemed to be an employee of a person paying the remuneration for those services to a service company or trust if the individual can establish, to the satisfaction of the Commissioner, that his or her performance of services was not in substance the holding of an office or employment of profit (sec 9A(4)).

In exercising his discretion under this provision, the Commissioner will have regard to whether or not the individual's performance of services displays the accepted characteristics of an office or employment of profit as opposed to a contract for services, as set down in case law.

STATUTORY EXEMPTIONS

¶2-0800 Statutory exemptions

Certain receipts which might normally be considered to be "income" are specifically excluded from a taxpayer's income computation under sec 8 and 9 of the *Inland Revenue Ordinance*. They are:

- **Consulate staff.** Official emoluments of consuls, vice-consuls and taxpayers employed on the staff of any consulate, who are citizens of the state which they represent (sec 8(2)(b)). In practice this exemption is extended to the staff of all official foreign government agencies (*Case* I35 (1999) HKRC ¶80-604 (*D81/98*)).
- **Commutation of pension.** A sum received by way of commutation of pension under:
  - (i) a recognised occupational retirement scheme upon termination of service, death, incapacity or retirement;
  - (ii) the *Pensions Ordinance*;
  - (iii) the *Pensions Benefits Ordinance*; or
  - (iv) the *Pensions Benefits (Judicial Officers) Ordinance* (sec 8(2)(c)).

  Certain limitations apply to the exemption from salaries tax of pensions which are received on termination of employment, see ¶2-2000.
- **Disability pensions.** Disability pensions granted under the *Pensions Regulations* (reg 31), the *Pension Benefits Ordinance* (sec 15(1)), the *Auxiliary Forces Pay and Allowances (Pensions) Regulation* (sec 3(1)) or the *Pension Benefits (Judicial Officers) Ordinance* (sec 15(1)) are exempt from salaries tax (*Exemption from Salaries Tax Order*).
- **Pensions related to non-Hong Kong employment.** Pensions attributable to services rendered in any office or employment outside Hong Kong, other than government employment (sec 8(2)(ca)).
- **Accrued benefits received from mandatory provident fund scheme attributable to mandatory contributions.** Accrued benefits received from the approved trustee of a mandatory provident scheme upon retirement from employment, death or incapacity, or permanent departure from Hong Kong, that are attributable to mandatory contributions by an employee and his or her employer (sec 8(2)(cb)) (see ¶2-2000).
- **Accrued benefits received from mandatory provident fund scheme attributable to voluntary contributions.** Accrued benefit received or taken to have received from the approved trustee of a mandatory provident scheme upon retirement, death or incapacity, that represents voluntary contributions. In the case of termination of service, the sum is

excluded from the relevant employee's income, to the extent that the amount is attributable to the employer's voluntary contributions and does not exceed the proportionate benefit calculated under sec 8(5) (sec 8(2)(cc)(ii); 8(4)) (see ¶2-2000).

- **Amounts (other than pensions) withdrawn from a retirement scheme.** Any sum (other than a pension) withdrawn from a recognised retirement scheme upon termination of service, death, incapacity or retirement. However, if the sum is withdrawn in the case of termination of service and it is attributable to contributions made by the employer, the amount excluded from the relevant employee's income is restricted to the amount that does not exceed the proportionate benefit calculated under sec 8(5) (sec 8(2)(cc)(i); 8(4)) (see ¶2-2000).
- **Monetary Authority provident fund benefits.** Benefits withdrawn from any provident fund scheme to which the Monetary Authority is a party which are received by any person appointed to be the Monetary Authority under sec 5A(1) of the *Exchange Fund Ordinance* or by any person appointed under sec 5A(3) of that Ordinance. The exemption of these benefits is subject to the same conditions and restrictions which apply in relation to the exclusion from tax of sums received from a recognised occupational retirement scheme, see ¶2-2000 (*Exemption from Salaries Tax (Monetary Authority) Order*).
- **Commonwealth emoluments.** Emoluments payable by Commonwealth Governments other than the Hong Kong Government to members of Her Majesty's forces and to persons in permanent services of those Governments' offices in Hong Kong (sec 8(2)(d)).
- **Forces pensions.** Wound and disability pensions granted to members of Her Majesty's forces (sec 8(2)(e)).
- **Service gratuities.** Gratuities granted to members of Her Majesty's forces for services rendered during war (sec 8(2)(f)).
- **War memorial pensions.** The Hong Kong War Memorial Pensions and any additional benefits paid under the *Hong Kong War Memorial Pensions Ordinance* (sec 8(2)(fa)).
- **Educational endowment.** Any amount arising from an educational endowment which is held by a person whose income is being computed and who is receiving full time instruction at an educational establishment (sec 8(2)(g)).
- **Central People's government servants temporarily in Hong Kong.** Emoluments payable by the Central People's Government to persons serving temporarily in Hong Kong on the same terms as they are employed in the Mainland China, but who are liable for overseas service or are recruited in the Mainland China specially for Hong Kong service (sec 8(2)(h)).

COMMON LAW INCOME PRINCIPLES

¶2-1100 Common law income principles

As the *Inland Revenue Ordinance* does not provide an exhaustive definition of "income" (see ¶2-0300), reference is made to common law principles which have been developed by the courts. Under common law, a payment is most likely to qualify as "income" if it fulfils the following criteria:

- it was derived beneficially by the recipient (see ¶2-1150);
- it was in money or money's worth (see ¶2-1200);
- it was a reward for services rendered (see ¶2-1250); and
- it had the qualities of periodicity, recurrence and regularity (see ¶2-1300).

Fulfilment of only one of the criteria is not normally decisive and the weight attached to each element varies from case to case.

¶2-1150 Beneficial receipt

To be "income" a payment must "come in" to the recipient taxpayer. The receipt should be a realised gain derived beneficially.

In other words, according to ordinary concepts and usages, income is "what comes into (the) pocket" (*Tennant v Smith* (1892) AC 150). Normally, a payment which does no more than save the taxpayer from incurring expenditure is not regarded as income because income is what "comes in" and not what is saved from going out (*Federal Commissioner of Taxation v Cooke & Sherden* 80 ATC 4140).

An amount of money does not need to be paid over to a taxpayer in order for it to "come in" as assessable income. It is enough if a payment is dealt with as the taxpayer directs (*Cooke & Sherden*).

The requirement that a gain must be derived *beneficially* in order to constitute "income" means that the amount must be received for the taxpayer's own benefit rather than being held by the taxpayer for the benefit, or on behalf, of another (*The Countess of Bective v FC of T* (1932) 47 CLR 417). For example: if Ms A received $500 to be disposed of as she wished then, all else being equal, the amount would have been derived beneficially by Ms A and would be taxable "income". If, however, Ms A was paid $500 on condition that she invest it and pay the proceeds to Mr B then the income would not have been derived beneficially by Ms A. She could not treat the amount as her own and dispose of it as she wished. The amount would not then be "income".

¶2-1200 Money or money's worth

To constitute "income" at common law there must have been a receipt of money or something capable of being turned into money.

It is not necessary for income to be received in the form of money. It is sufficient if the item is in a form which can be converted into money or money's worth (*Cross v London & Provincial Trust Ltd* (1938) 1 All ER 428).

In *Federal Commissioner of Taxation v Cooke & Sherden* 80 ATC 4140, taxpayers were awarded a free holiday as part of a sales incentive scheme. The holiday could not be sold or transferred. There could be no cash payment in lieu of the trip. According to the Court, as the benefit could not be converted into money or money's worth, it was not "income" and, therefore, was not assessable.

Free air tickets obtained through a frequent flyer program (with points obtained as a result of business travel) were not "income" because they were not money and could not be turned into a pecuniary account according to the Australian Federal Court in *Payne v FC of T* 96 ATC 4407. The tickets could be used only by the member of the program or by his or her appointed nominee. They were not transferable and, if sold, were subject to cancellation. The taxpayer was not taxable on the value of the tickets.

A taxpayer's right to be reimbursed by his or her employer for dental fees, which he or she had incurred and paid, was a benefit or perquisite which was convertible into money or money's worth, and so deemed to be taxable in *D56/86* IRBRD Vol 2, 323.

¶2-1250 Reward for services rendered

Receipts which are the product of personal exertion in employment are usually regarded as "income" at common law. Gains which are not linked to employment, such as gifts flowing from personal considerations, or "windfall" gains such as betting or lottery wins, are not.

A gift is only taxable as "income" if it is given for a reason which is connected with the recipient's employment. An example of an assessable gift is a tip paid in appreciation of the quality of services rendered. Such payments have been held to be income in a number of situations, including in the case of:

- a taxi-cab driver (*Calvert v Wainwright* (1947) 27 TC 475);
- a railway dining car waiter (*Penn v Spiers & Pond Ltd* (1908) 1 KB 766); and
- a railway porter (*Great Western Railway Co v Helps* (1918) AC 141).

Money collected by a professional cricket player from appreciative spectators was characterised as "income" in *Moorhouse v Dooland* (1955) 1 All ER 93. In that case, the taxpayer was a professional cricket player entitled under his contract of employment to make public collections from spectators whenever he performed outstanding cricket feats. The money collected on those occasions was held to be "income" as it was directly related to his

Termination payments

When considering whether a termination payment qualifies as taxable "income" it is essential to determine why it was made. A payment made out of personal esteem, for instance, is not regarded as "income" (*Seymour*). A payment made simply to discharge a personal obligation and not connected with the taxpayer's employment is also non-taxable. A taxpayer who was promised by his employer that his previous employment with another company would be taken into account when his severance pay was calculated was not assessed to salaries tax on the part of his severance payment which apparently related to his former employment (*D24/88* IRBRD Vol 3, 289). According to the Board of Review, the payment was not income from the taxpayer's employment. The payment represented a discharge of the director's personal obligation to the taxpayer and, therefore, was not a payment for services.

A termination payment constitutes taxable "income" only if it relates to the services rendered by the taxpayer during his or her employment. A termination payment which has been pre-arranged as part of the terms of employment may be regarded as a deferred payment for services rendered and, therefore, taxable income (*Henry v Foster* 16 TC 605; see also *Case* N42 (2004) HKRC ¶81-018 (*D36/03*); *Case* N30 (2004) HKRC ¶81-006 (*D12/03*); *Case* K10 (2001) HKRC ¶80-741).

The Court of First Instance in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2008) HKRC ¶90-209 adopted the following approach in determining the taxability of the termination payments:

(i) Look at the contract as a starting point — if a payment had been made upon premature termination which was not a contractual entitlement, it would be *prima facie* not income from employment ie not assessable.

(ii) On the other hand, payment made pursuant to the contract as an entitlement on early termination would be *prima facie* "income arising in or derived from the office. . .".

(iii) However, if it could be shown that the payment was truly compensation for loss of office or damages for breach of contract, it would not be assessable.

(iv) Damages for breach would logically not be provided for in the contract.

In the *Fuchs* case, the taxpayer received termination payment which was broken into three sums. Sum B (being "two annual salaries") and Sum C (being "the average of three previous annual bonuses"), which were made pursuant to the taxpayer's contract of employment, were the issues in question. The Court pointed out that Sum B had characteristics of being both chargeable and non-chargeable. The Court held Sum B to be non-taxable because its substance was in the nature of a payment the taxpayer would have received by virtue of his seniority in the circumstances that occurred. Sum C

was held to be taxable. The Court considered that it was made to ensure the employee received the bonus he might have received if the contract had continued for another year and it acted as an inducement. The Court was of the view that if the termination payment was truly a compensation for loss of office, there would have been one single sum only. The fact that the payment was broken into three sums implied that the sums were different in nature.

However, the Court of Appeal in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2010) HKRC ¶90-223 adopted a narrower approach and held that both Sum B and Sum C were chargeable to salaries tax. The Court was of the view that both payments were made pursuant to the contract of employment; the payments were not paid in abrogation of the contract of employment; they were either a reward for past services or an inducement to take up employment with the Hong Kong branch to provide future services.

The Court of Final Appeal in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2010) HKRC ¶90-234 referred to the basic charging provision, sec 8(1), in its analysis. Whether a payment received by an employee on termination of his or her employment is taxable depends on whether those amounts constitute income "from employment".

The Court stated that the taxpayer had received the payments exactly as stated in the employment contract. The rights that accrued to the taxpayer upon termination were obviously enforceable at law. He could have sued to recover those sums if the employer had failed to make payment. As such, Sums B and C were paid in satisfaction of the rights which had accrued to the taxpayer under the employment contract and were, therefore, chargeable as income "from his employment".

The termination payment paid to the taxpayer in *Case* Q24 (2007) HKRC ¶81-210 (*D71/06*) was held to be non-taxable as it was paid for the consideration of the total abandonment of all the contractual rights which the taxpayer had under her employment. Similarly, the Court of First Instance stated in *Mrs Murad, Barbara Ellen and others v Commissioner of Inland Revenue* (2010) HKRC ¶90-219 that whether the sums were "compensation for loss of office" was not the true test for deciding if a sum paid on earlier termination of an employment contract should be taxed. Disputes of this kind always involved a "loss of office" and sums paid on such occasion would often be described as "compensation". Rather, the correct test to apply or the emphasis should be on whether there was an abandonment or abrogation of contractual rights. In this case, the sums paid on termination of employment were found to be taxable for:

(i) the taxed sums were paid pursuant to the sums agreed in the service agreement.

him as it would not be possible to make a gratuity payment in advance of the payment of long service pay because by the terms of the employment contract, the taxpayer's gratuity was net of the long service pay due to him.

The Court further held that whether the taxpayer was entitled to long service payment was a question of law. The employer's view on its legal position in respect of long service or severance pay and the label given to the gratuity would have been irrelevant.

The Court of Appeal allowed the Commissioner's appeal by a majority in *Commissioner of Inland Revenue v Tsai Ge Wah* (2009) HKRC ¶90-212. The Court held that the Board had misapplied sec 31Y and as a result, the Board was wrong to find as a fact that $103,196 out of $251,280 represented a long service payment to the taxpayer. The Court agreed with the submission of the Commissioner's Counsel that no long service pay was in fact payable to the taxpayer having regard to the provisions of sec 31Y, given that the taxpayer had previously received well over $103,196 in the form of the earlier gratuities paid to him.

The Court also agreed that the earlier gratuities that had been paid to the taxpayer were clearly "gratuities based on length of service" and as such came within sec 31Y. In the present case, the amount of gratuities which had already been paid greatly exceeded the amount of long service pay to which the taxpayer would have been entitled. The effect of sec 31Y was that the taxpayer was not entitled to receive any amount of long service pay from the employer on termination of his employment. This point was not considered by the Board in reaching its conclusion nor did the Board consider the relevance of the previous gratuities received by the taxpayer.

If a long service or severance payment paid to a taxpayer exceeds the taxpayer's entitlements under the *Employment Ordinance*, the excess will be subject to tax. Also see *Case* O4 (2005) HKRC ¶81-060 (*D10/04*); *Case* L63 (2002) HKRC ¶80-864 (*D87/01*); *Case* L59 (2002) HKRC ¶80-860 (*D81/01*); *Case* L10 (2002) HKRC ¶80-811 (*D151/00*) and *Case* L40 (2002) HKRC ¶80-841 (*D51/01*). In *Case* E78 (1995) 1 HKRC ¶80-375 (*D32/95* IRBRD Vol 10, 195) a lump sum paid to the taxpayer upon the termination of his employment was calculated by his employer on the basis of his long service entitlements plus an additional sum for his long years of service. The additional sum was taxable.

Similarly, in *Case* F40 (1996) HKRC ¶80-418 (*D83/95*), a payment labelled "consolation money" which was paid to a taxpayer upon his retirement, in addition to his approved retirement benefits, was regarded as taxable since it was paid on account of his service with the company (see also *Case* O20 (2005) HKRC ¶81-076 (*D43/04*); *Case* K43 (2001) HKRC ¶80-774 (*D80/00*); *Case* H36 (1998) HKRC ¶80-544 (*D84/97*)).

If there has been no true dismissal or termination of employment, long service payments will be taxable (*Case* O65 (2005) HKRC ¶81-121 (*D28/05*); *Case* L1 (2002) HKRC ¶80-802 (*D131/00*); *Case* I63 (1999) HKRC ¶80-632 (*D104/98*); *Case* E15 (1995) 1 HKRC ¶80-312 (*D26/94* IRBRD Vol 9, 189); *Case* E16 (1995) 1 HKRC ¶80-313 (*D27/94* IRBRD Vol 9, 192)). It is the true nature of a payment in the relevant circumstances, not the label placed upon the payment, that will determine whether or not it is tax exempt (*Case* P22 (2006) HKRC ¶81-174 (*D16/06*); *Case* I27 (1999) HKRC ¶80-596 (*D59/98*); *Case* I26 (1999) HKRC ¶80-595 (*D58/98*)).

In *Case* J41 (2000) HKRC ¶80-709 (*D104/99*), an employee received a severance payment as the factory in Hong Kong was closed. He was re-employed to work in a China factory. Although the new employment letter was dated immediately after termination of the old employment, the Board held that as the new employment term was only finalised some time after, therefore, there was a technical break as distinguished from *Case* I12 (1999) HKRC ¶80-581 (*D25/98*). Thus, the payment was a severance payment and not taxable.

Compensation for loss of employment

The Inland Revenue accepts that a payment made as compensation for the loss of employment or for the settlement of a claim for damages for wrongful dismissal is not assessable to salaries tax. Such income does not arise from employment because the employment has been terminated. The circumstances in which a payment is made must be carefully examined to determine whether a payment is indeed compensation as opposed to a payment for services rendered, a gratuity or some other taxable sum.

A special payment received by the taxpayer on termination of his employment was confirmed to be compensation for loss of employment in *Case* D22 (1994) 1 HKRC ¶80-272 (*D43/93* IRBRD Vol 8, 323). The taxpayer's employment had been terminated by his employer in contravention of the terms of the employment contract. The employer therefore agreed to a termination package which included the compensation payment. The compensation payment had neither arisen out of the employment contract nor was it in return for services rendered by the taxpayer. In the Board's view it was clearly a payment made to terminate the contractual obligations of the employer and to compensate the taxpayer for the loss of employment.

Similarly, in *Case* L53 (2002) HKRC ¶80-854 (*D70/01*), the Board of Review agreed that the taxpayer had been forced to resign by the employer. It appeared to be a voluntary resignation to the outside world intentionally to preserve a harmonious image and to maintain both parties' reputations. The lump sum payment from the employer was thus held to be compensation for loss of office.

¶80-211 (*D24/92* IRBRD Vol 7, 273) because it was a reimbursement of non-deductible, domestic living expenses incurred by the employee.

In *Case* I57 (1999) HKRC ¶80-626 (*D142/98*), an employer waived a loan upon termination of the taxpayer's employment. This amount waived was included in the termination payment reported by the employer. As the assessment had been originally issued based on the termination payment reported by the taxpayer in his return, an additional assessment was issued by the Assessor. The taxpayer objected. The Board held the amount waived as taxable, although they did agree to reduce the assessment by the sum of one month's salary which was paid in lieu of notice.

In *Case* K44 (2001) HKRC ¶80-775 (*D83/00*), the taxpayer was granted an interest-free loan from the Government. Subsequently, the Government granted the taxpayer a partial waiver of the loan. The Board held that the same amount was assessable to the taxpayer at the point of waiver. See also *Case* N9 (2004) HKRC ¶80-985 (*D119/02*). Tax reimbursements paid to a taxpayer by his company were regarded as "income from employment" in *Case* A139 (1991) 1 HKRC ¶80-139 (*D106/89* IRBRD Vol 6, 391). The Board of Review, relying on the Privy Council's finding that a perquisite includes money expended in discharge of a debt of a taxpayer (*Glynn v The Commissioner of Inland Revenue* (1990) 1 HKRC ¶90-032), found it beyond argument that the tax reimbursements in question were chargeable to tax. It should be noted, however, that payments made for the benefit of an employee which discharge a liability of the paying employer are specifically excluded from the employee's income except in special circumstances (sec 9(1)(a)(iv); see further ¶2-1500).

The taxpayer in *Case* M108 (2003) HKRC ¶80-973 (*D89/02*) was entitled to a provident fund of 15.5% of his salary which would be paid either with salary or by such other arrangements as the taxpayer might request. The taxpayer asked his employer to pay the funds to a provident fund company chosen by him in the United Kingdom. The employer later on offered to the taxpayer a new scheme which was registered under the *Occupational Retirement Schemes Ordinance*. The taxpayer accepted the offer and elected to repay the total cash he received in lieu of the employer's provident fund contributions. The Board held that the amount received by the taxpayer from the employer through the provident fund company in United Kingdom fell within the definition of "perquisite" and was assessable as employment income under sec 9(1)(a). The Board considered that the exemption under sec 9(1)(a)(iv) was not available as the amount was not made in discharge of the employer's obligation towards the provident fund company but in discharge of the employer's own obligation to the taxpayer pursuant to the employment contract terms.

Study leave pay

According to the Board of Review there is no material difference between annual leave and study leave. Therefore, pay which was received by an employee of a Hong Kong university while he was on study leave overseas was found to be assessable to salaries tax in *Case* F9 (1996) HKRC ¶80-387 (*D40/95* IRBRD Vol 10, 275).

The pay received by the taxpayer while on study leave, according to the Board, was leave pay attributable to services rendered by the taxpayer in Hong Kong, in respect of his Hong Kong employment, and was taxable as such. The study leave pay could not be regarded as tax-exempt income derived from services rendered wholly outside Hong Kong as was contended by the taxpayer.

The taxpayer's submission that the taking of study leave constituted service was without substance having regard to the ordinary meaning of the word "leave" which is defined in the *New Shorter Oxford English Dictionary* as "(a) permission to be absent from one's normal duties, employment, etc; (b) absence from work etc; (c) a period of such absence".

Pre-commencement and termination payments

Payments made to taxpayers before the commencement of their employment, or after its termination, may be regarded as taxable income from employment depending upon the circumstances in which the payments are made. The status of such payments for salaries tax purposes is examined at ¶2-1250.

Income of members of religious orders

Dolan v "K" (1944) IR 470 represents the current position in Hong Kong. In that decision, that fact that a nun was required to hand over her salary for the benefit of her Order did not affect her liability to pay tax on that salary. The *Dolan* case was taken into consideration in *Case* C17 (1993) 1 HKRC ¶80-226 (*D42/92* IRBRD Vol 7, 420) in which remuneration received by a Roman Catholic priest from a charitable organisation was regarded as taxable income. The taxpayer unsuccessfully claimed that the remuneration was not salary since, by tradition, he was bound to give any salary he received to the Church.

The Inland Revenue, as an extra-statutory concession, does not raise assessments on members of religious orders if the members concerned are subject to a vow of poverty and receive income from the Order which they turn back to the Order. The taxpayer in *Case C17* (*D42/92*) sought relief under the extra-statutory concession. The facts of the taxpayer's case, however, did not meet the criteria.

A "recognised retirement scheme" is a collective term for the two types of retirement schemes that may enjoy tax benefits and means either a recognised occupational retirement scheme or a mandatory provident fund scheme (DIPN No 23 (Revised), para 10).

Retirement schemes previously approved by the Commissioner of Inland Revenue

The Registrar of Occupational Retirement Schemes assumed responsibility for the registration of retirement schemes from 19 November 1993. Previously, approval was granted to retirement schemes for taxation purposes by the Commissioner of Inland Revenue under the former sec 87A of the *Inland Revenue Ordinance*.

The *Occupational Retirement Schemes Ordinance* provided a two-year transitional period during which it was not necessary for retirement schemes to be registered or exempted from registration. During this transitional period, any retirement schemes which had received the Commissioner's approval under sec 87A before its repeal were regarded as "recognised occupational retirement schemes" for tax purposes. The transitional period expired on 15 October 1995. Accordingly, any retirement scheme that is neither operated by a foreign government, nor established under a Hong Kong Ordinance, is now required to be registered or exempted from registration under the *Occupational Retirement Schemes Ordinance* in order to be treated as a "recognised occupational retirement scheme" for tax purposes, notwithstanding that the scheme may have been approved previously under sec 87A.

Payments, representing employers' contribution, from recognised occupational retirement schemes under the former sec 87A of the *Inland Revenue Ordinance* are exempt from salaries tax. However, if the schemes' approval status have been subsequently withdrawn by the Inland Revenue Department, any payments (representing employers' contribution) from the schemes thereafter will be subject to salaries tax (*Case* I16 (1999) HKRC ¶80-585 (*D33/98* IRBRD Vol 13, 264)).

¶2-2000 Exemption of payments from recognised schemes

Employees are entitled to salaries tax concessions in respect of certain benefits received from "recognised occupational retirement scheme" and "mandatory provident fund scheme", both of which fall within the definition of "recognised retirement schemes" under sec 2(1).

Any sum received as a commutation of a pension from a "recognised occupational retirement scheme" is exempt from salaries tax. In addition, any sum (other than a pension) withdrawn from such a scheme is exempt from salaries tax, subject to the "proportionate benefit" limit set out in sec 8(5) in the case of a termination of service (sec 8(2)(c), (cc)(i); see ¶2-0800).

However, the scheme should be a "recognised occupational retirement scheme". Otherwise, any sum contributed to members under the scheme would be subject to salaries tax (*Case* I16 (1999) HKRC ¶80-585 (*D33/98*)). See also *Case* O39 (2005) HKRC ¶81-095 (*D83/04*).

In *Case* L14 (2002) HKRC ¶80-815 (*D9/01*), the taxpayer was a lecturer with a university in Hong Kong. The university established a staff terminal benefits scheme ("Scheme I"), which was registered under the *Occupational Retirement Schemes Ordinance*. The taxpayer and the university made contributions to the scheme.

From 1994 to 1996, the taxpayer fought and finally succeeded in her claim against the university that she suffered personal injuries in the course of her work. The taxpayer resigned later and her last day was 31 December 1997.

In December 1996, the university gave the members of Scheme I the irrevocable choice of either retaining or leaving the scheme on 1 February 1997. The taxpayer elected to leave Scheme I and received a net sum on 27 February 1997, including "the sum" being the university's contributions under the scheme.

The Board of Review held that the sum was chargeable under sec 9(1)(ab)(i). It found that the taxpayer's employment with the university subsisted well after 27 February 1997. Her alleged incapacity did not lead to the payment of the sum.

Accrued benefit received from the approved trustee of a mandatory provident fund scheme on a taxpayer's retirement, death, incapacity or permanent departure from Hong Kong as is attributable to mandatory contribution is exempt from salaries tax (sec 8(2)(cb)). Where a taxpayer permanently departed from Hong Kong but without termination of service, the sums withdrawn attributable to the employer's mandatory contribution are not taxable, but those attributable to the employer's voluntary contributions are taxed in full (DIPN No 23 (Revised), para 29).

The following summarises whether certain sums or accrued benefits received from a "recognised occupational retirement scheme" and a mandatory provident fund scheme are exempt or assessable to tax (DIPN No 23 (Revised), para 20).

¶2-2150 "Rental value"

There are two basic methods of calculating a residence's "rental value". The rental value of hotel or boarding house accommodation is calculated differently than the rental value of other residences. A residence's rental value may be apportioned if an employee performs services outside Hong Kong.

Standard method of calculating rental value

The rental value of a residence provided rent-free by an employer is normally deemed to be 10% of the income which the taxpayer derives from that employer. The percentage is calculated on the taxpayer's income after deducting:

- any outgoings, expenses and capital allowances allowed as deductions under sec 12(1)(a) or (b) (see ¶2-4900ff) to the extent to which they are incurred during the period for which the residence is provided; and
- any lump sum payment or gratuity paid on termination of the employment (sec 9(2)).

Example

If Mr X was provided with rent-free accommodation by his employer during a year of assessment, in addition to receiving his annual salary of $300,000, and was entitled to $10,500 worth of deductions, Mr X's income for that year would be calculated as follows:

		$
Salary		300,000
LESS		
Allowable deductions	–	10,500
PLUS		
Rental value (10% × (300,000 – 10,500))	+	28,950
EQUALS		
Mr X's income	=	318,450

All of the taxpayer's income is taken into account for the purposes of calculating the "rental value" of a residence, including any allowances or fringe benefits which the taxpayer may have received. Removal expenses paid to a taxpayer who was required by his employer to occupy a room at a designated place have been included in the calculation of the rental value of premises (*D25/86* IRBRD Vol 2, 258). An education allowance was added to the taxpayer's salary in order to compute the rental value of his quarters in *Case* A59 (1991) 1 HKRC ¶80-059 (*D16/90* IRBRD Vol 5, 136).

The taxpayer in *Case* M91 (2003) HKRC ¶80-956 (*D60/02*) failed to convince the Board of Review that the contract gratuity and the backpay he received from his employer were made upon "the termination of employment of the employee" within the meaning of sec 9(2). The taxpayer was employed as a resident engineer under a service contract which granted him a gratuity payment upon completion of the relevant service period. He was subsequently transferred to work on another project and a new service agreement was signed. The Board held that the new agreement was basically the same as the old agreement and the substitution of the new agreement for the old agreement did not amount to a termination of employment. It considered that the gratuity payment and the backpay were part of the taxpayer's remuneration and not severance payment, and therefore should have been included in the calculation of rental value.

The rental value of premises provided by an employer, and occupied by two or more employees, is not pro-rated between the occupants for salaries tax assessment purposes. There is no provision for the pro-rating of "rental value" in the Ordinance. For each taxpayer occupying a flat provided by the employer, the rental value is 10% of the taxpayer's income (*Case* A109 (1991) 1 HKRC ¶80-109 (*D78/90* IRBRD Vol 6, 1)).

Alternative rental value

An employee may elect to substitute the standard rental value calculated as above with the rateable value included in the valuation list prepared under the *Rating Ordinance* or, if the residence is not included in the list, with the rateable value ascertained in accordance with Pt III of that Ordinance.

Electing the alternative rental value is rarely to a taxpayer's advantage.

The market value of the premises is not relevant and cannot be substituted for the standard rental value or the rateable value (*Case* E26 (1995) 1 HKRC ¶80-323 (*D42/94* IRBRD Vol 9, 275)).

Rental value of hotel, hostel or boarding house

The rental value of a hotel, hostel or boarding house is:

- 8% of the taxpayer's income — if the accommodation consists of no more than two rooms; and
- 4% of the taxpayer's income — if the accommodation consists of no more than one room.

A single "room" includes a suite of rooms with one bedroom and other rooms such as a bathroom or sitting room (*D23/84* IRBRD Vol 2, 134).

In *Case* O44 (2005) HKRC ¶81-100 (*D91/04*), the taxpayer claimed that the place of residence provided to him was a "hotel, hostel or boarding house" as provided by sec 9(2)(a) of the *Inland Revenue Ordinance* and as such the deemed rental value should be computed at 4% instead of 10% of assessable income.

Rent-free accommodation v rent allowance

The tax treatment of rent-free accommodation is significantly different from the tax treatment of a rent allowance. While it is only the "rental value" (calculated as a percentage of remuneration under sec 9(2)) that is taxable in the case of rent-free accommodation, a rent allowance paid to a taxpayer is taxable in full according to the general definition of "income" provided in sec 9(1)(a) (see ¶2-0300) (*Case* H15 (1998) HKRC ¶80-523 (*D33/97* IRBRD Vol 12, 228); *D16/83* IRBRD Vol 2, 54).

Proper control over housing benefit essential

An employer must exercise proper control over the provision of a housing benefit if it is to be accepted as the provision of rent-free accommodation rather than the payment of a fully taxable rent allowance. Such control would include the review of lease agreements and rental receipts to ensure that rent payments or refunds are used for their designated purpose.

In *Case* F46 (1996) HKRC ¶80-424 (*D92/95* IRBRD Vol 11, 173) the Board of Review had to determine whether a portion of the monthly lump sum remuneration received by a taxpayer was a rent refund, or simply an allowance which would be fully chargeable to tax under sec 9(1)(a). A key factor in the Board's decision was the control exercised by the employer over the housing benefit provided to the taxpayer.

In this case, the taxpayer paid monthly rent of $15,000 for his residence and received monthly remuneration which his employer agreed to include a contribution towards housing. The Commissioner's view was that the taxpayer simply received a fixed monthly salary, or a salary and a rent allowance, and that the whole amount was subject to tax. On appeal to the Board of Review the taxpayer argued that his remuneration package was at all times allocated between salary and contribution to rent and that sufficient control was exercised by his employer for his rental benefit to be regarded as a rent refund. The Board of Review agreed with the taxpayer.

The taxpayer's original contract of employment had provided for a contribution to the cost of housing and an amount of $15,000 per month had been agreed upon when the taxpayer arrived in Hong Kong and found suitable accommodation. The taxpayer had at all relevant times paid rent of $15,000 per month and had submitted a copy of the lease and all relevant rent receipts to his employer. On the basis of these facts, the Board found that the payments of $15,000 per month made by the employer to the taxpayer within his lump sum remuneration were refunds of rent. Accordingly the taxpayer was assessable to tax, not on the amount of the rent refund, but on the "rental value" of the premises calculated under sec 9(2).

A different result arose in *Case* E71 (1995) 1 HKRC ¶80-368 (*D19/95* IRBRD Vol 10, 157). In that case, amounts which the taxpayer claimed were rent payments

and refunds made by his employer were found to be cash allowances placed generally at the disposal of the taxpayer. The employer had not been concerned whether the payments were actually spent by the taxpayer on housing. Accordingly, the Board found that the payments were simply allowances which were properly subject to tax under sec 9(1)(a) (see also *Case* M77 (2003) HKRC ¶80-942 (*D40/02*); *Case* L53 (2002) HKRC ¶80-854 (*D70/01*); *Case* L9 (2002) HKRC ¶80-810 (*D149/00*); *Case* I9 (1999) HKRC ¶80-578 (*D21/98*)).

In *Case* I84 (2000) HKRC ¶80-653 (*D18/99* IRBRD Vol 14, 204), the taxpayer was entitled to housing allowance as part of his income under the terms in the employment contract irrespective of whether he had incurred the housing expenses; the amount was not intended nor paid as a refund to him under sec 9(1A)(ii). See also *Case* N41 (2004) HKRC ¶81-017 (*D35/03*).

Labelling income as "rent refund" not enough

The taxpayer in *Case* G31 (1997) HKRC ¶80-469 (*D34/96* IRBRD Vol 11, 497) failed to convince the Board of Review that amounts received by him were rent refunds. It was not enough that the taxpayer and his employer had entered into an agreement under which portions of the taxpayer's income were labelled as rent reimbursements.

In *Case G31* (*D34/96* IRBRD Vol 11, 497) the taxpayer, who was paid on a commission only basis, had entered into an agreement with his employer for the reimbursement of rental expenses. The agreement was entered into specifically to take advantage of the tax benefits under sec 9(1A).

Under the agreement the taxpayer was reimbursed for his rental expenses and received cash remuneration to the extent that his commission earnings exceeded the amount of rental expenses already reimbursed. The agreement was conditional upon the taxpayer providing rent receipts. If his commission earnings fell below the rental expenses he was required to make up the shortfall. Conversely, if he did not incur rental expenses, and produced no rental receipts, he would be paid the full amount of his remuneration in the form of commission.

The Board of Review rejected the taxpayer's rental refund claim on the basis that, in reality, the taxpayer and his employer had not agreed upon an employment package comprised of the two components of rent refund and commission. Rather, the taxpayer's package was comprised only of commission, subject to the agreement that, depending on the commission earned, part of the commission would be labelled as rent refund. In fact the whole amount was commission earned on an agreed commission pay-out scale. The arrangement entered into by the parties did not convert taxable commission into rent refund within the meaning of sec 9(1A).

should be based on the share value at the time the share certificates are available for disposal (*Case* J7 (2000) HKRC ¶80-675 (*D43-99*)).

When salaries tax is chargeable (or just potentially to be chargeable; irrespective of the ultimate outcome (DIPN No 38 (Revised), para 34)) under sec 9(1)(d) on a gain realised by the exercise of a right, then salaries tax is not chargeable under any other provision of the Ordinance for the receipt of that right (sec 9(5)). This provision prevents a charge to salaries tax arising at the time the option is granted, as occurred in *Abbott v Philbin* 39 TC 82, and double taxation is avoided.

In March 2008, the Inland Revenue Department issued revised DIPN 38 which added a new section addressing the assessability of stock award benefits, as well as an analysis of reporting and administration considerations.

In determining when stock awards will be taxed, the new DIPN 38 (Revised) focuses on the point at which the employee participant is regarded as fully entitled to ownership of the shares, or when the employee is entitled to the full economic benefit of the shares.

The Inland Revenue Department outlines two approaches: the upfront approach and the back-end approach.

The upfront approach addresses plans in which stock is awarded but is subject to some restrictions. According to the Inland Revenue Department, the employee receives a benefit in the form of the shares at the time of grant, and he or she will be assessed at this time (ie upfront). Salaries tax will be chargeable on the market value of the stock at the date of grant with no subsequent tax charge on dividends received or on capital growth, if any.

The back-end approach addresses plans in which specific conditions have to be satisfied before the stock is vested in the employee. It is the Inland Revenue Department's position that when the stock is granted, the employee receives only a promise to the shares; vesting does not take place until the relevant conditions are satisfied. Salaries tax will be chargeable on the market value of the stock at the date of vesting (ie the point at which rights to the stock pass to the employee).

Similar to the provisions applicable to stock options, when an employee is departing Hong Kong permanently and there are stock awards assessable under the back-end approach, the employee may elect to have all unvested shares to be treated as vested at the time of departure from Hong Kong ("deemed vesting election"). Once an election is made, it cannot be withdrawn. On the other hand, the Inland Revenue Department will not seek to raise an additional assessment subsequently simply because the value of the stock has increased at the time of actual vesting.

IDENTIFYING "EMPLOYMENT" OR "OFFICE"

¶2-2800 Identifying an "office"

An "office" has been described as:

> "a subsisting, permanent, substantive position which had an existence independent of the person who filled it, and which went on and was filled in succession by successive holders": *Great Western Railway Co v Baxter* (1920) 3 KB 266.

The office of director is an "office" for salaries tax purposes and, accordingly, director's fees attract salaries tax. In *D6/88* IRBRD Vol 3, 154, the taxpayer, a director of eight companies, was assessed to salaries tax on his director's fees. The taxpayer's argument that his activities were those of a professional and that his fees should have been assessable to profits tax, rather than salaries tax, was rejected. The Board decided that the position of a director is an "office".

For the source of office income, see ¶2-3350.

¶2-2850 Identifying "employment"

Income is derived from "employment" if a relationship of master and servant exists between the taxpayer and the employer, in other words, where there is a "contract of service" as opposed to a "contract for services" (*Cassidy v Ministry of Health* (1951) 1 All ER 574 and D19/78 IRBRD Vol 1, 323). Income derived by a self-employed taxpayer or an independent contractor does not attract salaries tax but is normally assessable to profits tax.

Control test

The original test for determining whether a master and servant relationship exists focuses on the amount of control exercised by the employer on the basis that "a servant is a person subject to the command of his master as to the manner in which he shall do his work" (*Yewens v Noakes* (1880) 1 TC 260, CA (quoted in DIPN No 25)).

The extent to which a taxpayer is under the direction and control of another person is still an important consideration in determining whether a relationship of master and servant exists (*Narich Pty Ltd v Commissioner of Payroll Tax (NSW)* 84 ATC 4035). It does not always follow, however, that taxpayers who are engaged to do work are independent contractors simply because there is no control or because the control is insignificant or negligible (*D67/87* IRBRD Vol 3, 97).

See also *Case* H55 (1998) HKRC ¶80-563 (*D121/97*).

Islands of Country f. Both companies were ultimately owned by one Company G in Country a. The taxpayer tried to justify his omission of income from Company K on the basis that the employment duties for Company K were all performed outside Hong Kong. The Board of Review considered that there was in reality only one employment and that was with Company B-AP. Company K had no staff. When the taxpayer was made redundant in 1998, Company B-AP issued the termination letter (which covered Company K as well) and Company B-AP made the notice in lieu and last two salary payments for Company K. These were recorded in the accounts of Company B-AP.

¶2-3300 Extension of basic charge to non-Hong Kong employees working in Hong Kong

The basic charge to salaries tax (sec 8; see ¶2-0300) is specifically extended to include all income derived from services rendered in Hong Kong, including leave pay attributable to those services (sec 8(1A)(a)). Liability to salaries tax arises under the extended charge when a taxpayer provides services in Hong Kong, even though his or her employment is not technically located in Hong Kong. The extension applies only to employment income, not to income from an office of profit.

Qualification of extension

If a non-Hong Kong employee only renders services in Hong Kong during visits which total not more than 60 days in a year of assessment, then the income derived from those services is exempt from assessment to salaries tax (sec 8(1B)).

For more on the "60 days rule", see ¶2-3700ff.

Apportionment

When a non-Hong Kong employee falls within the extension imposed under sec 8(1A)(a), his or her total income is apportioned. The apportionment is normally made on the basis of the period of time the taxpayer spent in Hong Kong — that is, on a "time-in, time-out" basis (see ¶2-3850). Only that portion of his or her income which relates to services rendered in Hong Kong is assessable to Hong Kong salaries tax.

The nature or importance of the services rendered in Hong Kong is not relevant when apportioning income on a "time-in, time-out" basis. Income from services rendered in Hong Kong will be apportioned and chargeable to Hong Kong salaries tax even if the work done in Hong Kong consists only of non-productive negotiations or other preparatory work (see *Case* G12 (1997) HKRC ¶80-448 (*D1/96* IRBRD Vol 11, 290)).

Apportionment may be made on a different basis than the "time-in, time-out" approach only in certain exceptional circumstances. For example, an apportionment may be made on the basis of the actual remuneration attributable to services rendered in Hong Kong if the employee can establish that the rate of remuneration for the services rendered outside Hong Kong was substantially greater than the rate received in Hong Kong (DIPN No 10 (Revised), para 29).

The "time-in, time-out" basis of apportionment may be precluded by an express provision of a taxpayer's employment contract. However, there would have to be a provision in the contract specifically allocating the taxpayer's income in relation to the services rendered by the taxpayer inside and outside Hong Kong. Otherwise, there would be no justification for allocating a higher level of income to the taxpayer's services rendered outside Hong Kong (see *Case* G37 (1997) HKRC ¶80-475 (*D53/96* IRBRD Vol 11, 586)).

Employees should include, in their salaries tax return, both remuneration received locally and all other remuneration related to their employment (eg receipts from an overseas parent company or head office) for apportionment purposes.

¶2-3350 Source of office income

Taxpayers who hold an office of profit (eg company directors) are liable to pay salaries tax on any fees paid to them for their services if the control and management of the corporation or entity in which they hold the office is exercised in Hong Kong. Officers' fees are chargeable to tax under the basic charge in sec 8(1). The officer's residence is irrelevant.

An office is located in the place where control and management are exercised. The officer's services are also regarded as being rendered in that place (*McMillan v Guest* 24 TC 190). Therefore, if an office of director, for instance, is controlled in Hong Kong, any fees derived from the office are said to arise in Hong Kong, even if the director actually resides out of the territory.

Neither the extension of salaries tax liability to services rendered in Hong Kong (see ¶2-3300) nor the exemption for services rendered outside Hong Kong (see ¶2-3600) has any relevance to an officer's fees. Both relate only to employment.

¶2-3400 Source of pension income

Pension income is derived from Hong Kong if the fund from which it is paid is managed and controlled in Hong Kong. Any portion of a pension which is attributable to services rendered in any office or employment outside Hong Kong is, however, exempt from tax. This exemption applies even if the ordinary source of the pension is Hong Kong (sec 8(2)(ca)). The exception to this is if the taxpayer was employed outside Hong Kong by the Government.

ASSESSABLE INCOME

¶2-4500 "Assessable income" defined

The "assessable income" of a taxpayer is the total income accruing to him or her from all sources in a year of assessment (sec 11B). The term "year of assessment" is discussed at ¶2-4550.

Income *accrues* to a taxpayer when he or she becomes entitled to claim payment of it. However, income can only be included in the taxpayer's assessable income if it has been *received*. Income which has accrued but has not been received is not assessable. These concepts are clarified at ¶2-4650 and ¶2-4700.

The Ordinance's definition of assessable income (sec 11B) states that it includes income "from all sources". This phrase is qualified, however, by the basic charging section (sec 8) which dictates that only income which arises in or is derived from Hong Kong (see ¶2-3000) is chargeable to salaries tax.

¶2-4550 "Year of assessment"

A "year of assessment" for the purposes of the *Inland Revenue Ordinance* is the year commencing on 1 April. Salaries tax is charged on a current year basis. That is, salaries tax liability is based on the actual income of the relevant year of assessment.

Example — Basis period

The basis period for the 2011/12 year of assessment is 1 April 2011 to 31 March 2012. A taxpayer who is employed in one or more employment or offices during the period from 1 April 2011 to 31 March 2012 will be charged to salaries tax on his or her total net assessable income from all employment and offices, for the 2011/12 year of assessment.

¶2-4600 Commencing or ceasing to derive income

For the purpose of ascertaining assessable income under sec 11B, taxpayers are deemed to commence (or to cease) to derive income whenever they commence (or cease) to:

- hold any office or employment of profit; or
- become entitled to any pension (sec 11C).

The process of determining whether a taxpayer has commenced or ceased employment is simplified to an extent by reporting requirements set down in the Ordinance. Employers have a duty to notify the Commissioner whenever a person who is likely to be chargeable to salaries tax commences or ceases employment (sec 52(4), (5); see ¶9-3100 and ¶9-3200). Nevertheless, in certain situations it can be difficult to resolve whether a taxpayer's office or employment has ceased or been terminated.

Whether a taxpayer's employment has been terminated is ultimately a question to be determined on the facts. It is important to remember that there is a distinction between a contract of employment and the employment itself (*Case* A135 (1991) 1 HKRC ¶80-135 (*D101/89* IRBRD Vol 6, 375)). A taxpayer's duties and terms of employment may change, and he or she may even be employed over a period of time under different contracts. This does not necessarily mean, however, that the taxpayer's employment itself has not been continuous (see *Case A135* (*D101/89*); *D37/88* IRBRD Vol 3, 360; *D14/86* IRBRD Vol 2, 250). The entire facts must be considered.

Cessation of remuneration

The mere cessation of remuneration may not cause an office to cease to be an office of profit (*Henry v Galloway* (1933) 17 TC 470). Taking leave without pay for instance does not amount to a cessation of employment. A taxpayer who had taken leave without pay from his employment unsuccessfully claimed that he had ceased to hold an office or employment for profit in *BR 3/71* IRBRD Vol 1, 23. The argument failed because the taxpayer had intended to return to duty at the end of the leave period and his employment contract had not been terminated.

Re-employment by same employer

A complex situation arises when an employee resigns or retires from employment but is subsequently re-employed by the same employer on different terms. Whether or not this constitutes cessation of an office or employment depends upon the extent to which the terms of employment have been changed and any differences in responsibilities and duties. If the terms of employment are not substantially different, there will have been no cessation *Case* I12 (1999) HKRC ¶80-581 (*D25/98*); *BR 3/73* IRBRD Vol 1, 103.

However, in *Case* I20 (1999) HKRC ¶80-589 (*D43/98*), the Board found that there had been a breach of contractual rights between the employer and the taxpayer. The long service fund that had been paid with the loss of employment was therefore held not to be taxable.

If an employee directs an employer to deal with his or her income in a certain way, such as instructing the employer to pay a third party, that income will have been dealt with on the employee's behalf and is deemed to have been received (*Case* E13 (1995) 1 HKRC ¶80-310 (*D22/94*)).

In *Case* E46 (1995) 1 HKRC ¶80-343 (*D65/94* IRBRD Vol 9,369), an employee's contributions to a pension fund which were deducted directly from his salary could not be excluded from his assessable income as claimed by the employee. The income from which the contributions had been deducted had accrued to the taxpayer and the amounts of the contributions had been "received" by the taxpayer as they had been dealt with on his behalf.

Payments made to a third party *on behalf* of a taxpayer must be distinguished from payments made to a third party in place of the taxpayer. A taxpayer cannot be assessed to tax on income which he was never entitled to receive. This was demonstrated in *Case* E4 (1995) 1 HKRC ¶80-301 (*D11/94*) in which it was found that a taxpayer who had arranged for a substitute worker to take over his duties when he left his employment was not assessable to salaries tax on the income which was paid to the substitute worker. When the taxpayer left his employment the substitute worker was paid the salary which would have been paid to the taxpayer. The substitute worker was employed and paid directly by the employer. The taxpayer was not entitled to receive any payment from the employer during the period that the substitute worker was employed; he did not employ the substitute, nor did he exercise any control over him. The taxpayer was not liable to pay tax on money which had been paid to the substitute not on behalf of, but in place of, the taxpayer.

Income received but not accrued

Just as income which has accrued but has not been received by a taxpayer is not assessable to salaries tax (see ¶2-4650), income which has been received but which has not accrued to the taxpayer is not regarded as assessable income. A Hong Kong government contract officer was paid a gratuity four days before the date on which he became legally entitled to it in *BR 13/74* IRBRD Vol 1, 159. It was found that the gratuity did not accrue, and was therefore not chargeable to salaries tax, on the date it was received.

A taxpayer who refunded her final month's salary to her employer in lieu of notice was assessed to salaries tax on the refunded sum in *D15/88* IRBRD Vol 3, 223. She claimed that the sum was not chargeable to salaries tax because it should have been treated as if she had never received it. However, the Board found that the sum was assessable. It did not matter whether the amount was paid and then refunded or if there was a set-off and the taxpayer physically received one month's less salary. The set-off implicitly involved receipt of the month's salary which would therefore be chargeable to tax.

¶2-4750 Spreading back lump sum payments

A lump sum paid to a taxpayer upon the cessation of his or her employment can be spread back over the period of employment (sec 11D(b)(i)). The following payments can be related (or spread) back and regarded as income which has accrued during an employee's period of service:

- a lump sum payment or gratuity paid upon retirement from (or termination of) an office or employment;
- a lump sum payment or gratuity paid upon the retirement from (or termination of) any contract of employment; or
- a lump sum payment of deferred pay or arrears of pay.

The spreading back provision does not apply to leave payments (*D21/84* IRBRD Vol 2, 130).

Lump sum gratuities received other than upon retirement or termination, ie while a taxpayer is still employed, are not permitted to be spread back under sec 11D even though they may relate to previous years of service (*Case* E19 (1995) 1 HKRC ¶80-316; (*D39/94* IRBRD Vol 9, 204)).

When an employment contract is renewed, a lump sum which was paid upon the conclusion of the original contract can be spread back. Spreading back a marriage gratuity paid to an employee upon retirement has been allowed although the employee was subsequently re-employed on month-to-month terms (*BR 17/76* IRBRD Vol 1, 223).

Time limit for spreading back payments

Payments may only be spread back over a maximum of three years. If the employee's period of service exceeds three years, the payment is regarded as income accruing at a constant rate over the three years up to either the date on which the employee was entitled to claim the payment or the final day of employment, whichever was earlier.

The opportunity to spread back a lump sum payment is available irrespective of whether the payment is paid to a taxpayer during his or her employment or after the employment has ceased.

Application for spreading of payment

A taxpayer must apply in writing within two years of the end of the year of assessment in which a lump sum was paid in order to claim the advantage of spreading back. Normally, the Department will inform a taxpayer when it is clear that it would be to his or her advantage to make the election. The spreading calculation may even be made when no formal application is lodged.

expenses incurred for business purposes. If they fail to do so, the deduction is not allowed (*D25/87* IRBRD Vol 2, 400).

In *Case* I18 (1999) HKRC ¶80-587 (*D39/98*), the taxpayer received a mileage allowance for his home-to-office journeys. He claimed a deduction in respect of the mileage allowance as being capital expenditure depreciation on the car he had purchased. The Board looked at whether the expenses had been incurred wholly, exclusively and necessarily for the production of the assessable income. Although the taxpayer was required to travel between places of work in District X, he was not required to drive his own car for such travels. Hence, the appeal was dismissed.

See also *Case* R35 (2008) HKRC ¶81-253 (*D11/08*); *Case* R16 (2008) HKRC ¶81-234 (*D26/07*) and *Case* 015 (2005) HKRC ¶81-071 (*D35/04*).

¶2-5100 "Necessarily" incurred

To be deductible an outgoing or expense must have been *necessarily incurred* in the production of assessable income. The term "necessarily" is strictly interpreted as meaning: essential to the conduct of employment. To qualify as a deduction, therefore, it is not sufficient that the expenditure was desirable or that it assisted in the production of income. The expenditure must have been vital such that it would have been impossible for the taxpayer to have produced the income without incurring the expense.

Expenditure is not *necessarily incurred* simply because an employer requires it to be incurred. The test is not whether an employer imposes an expense, but whether the taxpayer's duties could not be performed without incurring the expense. A taxpayer who was required by his employer to join a club in order to foster business contacts was not entitled to a deduction for the subscriptions paid to the club (*Brown v Bullock* (1961) 1 WLR 1095).

It is not enough that it was desirable for the taxpayer to incur the expenses in question; it must have been essential. When expenses are not incurred to satisfy a practical need arising from the circumstances of the taxpayer's employment, they are not deductible. A taxpayer who incurred expenses in undertaking a course of study was not entitled to a deduction because the course was not essential; it was only desirable (*Case* A15 (1991) 1 HKRC ¶80-015 (*D50/89* IRBRD Vol 4, 527)).

A nightclub manageress successfully claimed as deduction in the production of assessable income the amount paid to another person for introducing public relations staff to her (*Case* K42 (2001) HKRC ¶80-773 (*D79/00*)).

A travel agent could not deduct travel expenses from his income because they were incurred as a matter of convenience rather than practical necessity (*D25/87* IRBRD Vol 2, 400). A lecturer was not entitled to a deduction for conference expenses because they were not necessarily incurred in the performance of his duty to contribute to scholarship but had been incurred on

account of his personal circumstances or volition (*Case* A46 (1991) 1 HKRC ¶80-046 (*D89/89* IRBRD Vol 6, 328)).

A lecturer could not deduct the discounts and subsidies as well as his loss of cash from theft, which arose from his order of the textbooks from the publishers for sale to the students. It was because the loss was not necessarily incurred in the production of his assessable income (*Case* I76 (2000) HKRC ¶80-645 (*D8/99*)).

In *D67/87* IRBRD Vol 3, 97 a musician who was required to engage and pay substitute musicians if he was absent from work was not entitled to a deduction for the salaries he paid to them. This was because the taxpayer had not established that the alleged payments were necessarily incurred in the sense that, on each occasion when he engaged a substitute, he did not have the choice of performing the duties in person.

¶2-5150 "Incurred" defined

Only an established liability, or a definite commitment, arising in the year of assessment in which a deduction is sought, is considered to have been *incurred* in the production of assessable income in that year. It is not essential that any payment actually be made during a year of assessment. Rather, if an actual and known liability of an ascertainable amount exists on the last day of the year of assessment, a deduction will be allowed. An anticipated future outgoing or expense, however, is insufficient to qualify for deduction.

¶2-5200 "In the production of assessable income"

There must be a substantial connection between expenditure and assessable income before the expenditure will qualify as an allowable deduction. It has been stated that the requirement that expenses must be incurred "in the production of assessable income" is not materially different from the United Kingdom requirement that expenses be incurred "in the performance of the duties of the office or employment of profit" (*Commissioner of Inland Revenue v Humphrey* (1970) 1 HKTC 451). The interpretation of the requirement is strict and narrow. If there is no evidence of a connection between expenditure or payments made by a taxpayer, and the taxpayer's income, the claim for a deduction must fail (*Case* O22 (2005) HKRC ¶81-078 (*D45/04*); *Case* B21 (1992) 1 HKRC ¶80-182 (D59/91 IRBRD Vol 6, 445)).

To be incurred *in the production of assessable income*, expenditure must do something more than enable the duties of employment to be performed. The expenditure must be incurred in the performance of those duties. Thus, in the *Humphrey* case, travelling expenses incurred by a taxpayer in getting to his place of employment were not allowed as deductions since, when travelling to his place of work, the taxpayer was not on duty.

Under sec 26E(6A), if a person revokes a claim under sec 26E(6) after six years from the expiration of the year of assessment to which the claim relates, the assessor may make an additional assessment of the tax payable in consequence of the revocation within two years after the revocation. Section 60(1) will apply to the additional assessment as if it were an assessment made under that section.

Interest on premium paid to the Hong Kong Housing Authority

In *Case* L11 (2002) HKRC ¶80-812 (*D2/01*), the taxpayer and his wife jointly purchased a flat from the Hong Kong Housing Authority ("the Authority"). There were restrictions on the alienation of the flat which included the payment of a premium to the Authority. After his wife passed away, the flat was vested in the taxpayer. The taxpayer subsequently applied to the Authority for assessment of the premium. The taxpayer financed payment of the premium by way of a bank loan. The taxpayer claimed a deduction for home loan interest in respect of the amount borrowed.

The Board of Review confirmed the disallowance of the home loan interest claimed in respect of the premium. It held that the premium was the consideration for removal of the restriction over the taxpayer's subsisting dwelling. The premium was not deferred consideration for the acquisition of the flat.

See also *Case* N66 (2004) HKRC ¶81-042 (*D87/03*) and *Case* M26 (2003) HKRC ¶80-891 (*D139/01*).

¶2-6750 Limitations on deduction

A taxpayer is not eligible for a deduction for home loan interest under sec 26E if:

(i) the home loan interest is allowable as a deduction under any other section of the *Inland Revenue Ordinance*;

(ii) home loan interest paid for another dwelling has been allowed to the taxpayer as a deduction for the same year of assessment (other than by virtue of sec 26E(3)(b), which allows an aggregate deduction in respect of multiple home loans, see above); or

(iii) deductions for home loan interest have already been allowed to the taxpayer for ten years of assessment, whether continuous or not, and whether in respect of the same dwelling or any other dwelling (sec 26E(4)).

¶2-6800 Nomination for deduction from spouse's income

If a taxpayer is entitled to a deduction for home loan interest under sec 26E in a particular year of assessment, but has no income, property or profits chargeable to tax under the *Inland Revenue Ordinance*, the taxpayer may nominate his or her spouse to claim the deduction for that year of assessment. This is subject to the condition that the spouse must be living together with the taxpayer (sec 26F(1)).

Once a taxpayer has made such a nomination, he or she will cease to be entitled to the deduction which has been passed on to his or her spouse (sec 26F(2)). The Commissioner will notify the taxpayer in writing about the nomination (sec 26F(3)).

When a nomination is made by a taxpayer for the deduction of home loan interest from his or her spouse's income, it can only be revoked by the taxpayer by notice in writing to the Commissioner within six months after the date on which the Commissioner has notified the taxpayer about the nomination in accordance with sec 26F(3) (sec 26F(4)(a)). Where a nomination is revoked under sec 26F(4)(a), the nomination will be deemed not to have been made (sec 26F(4)(b)).

CONTRIBUTIONS TO RECOGNISED RETIREMENT SCHEMES

¶2-6900 Deduction for contributions to recognised retirement schemes

Section 26G allows salaries taxpayers and taxpayers electing personal assessment to claim deductions for contributions to recognised retirement schemes, subject to certain limitations.

A taxpayer will be able to claim a deduction of up to $12,000 per year of assessment in respect of contributions to a "recognised retirement scheme" (sec 26G(1)–(2), Sch 3B).

Deductions will be available for contributions to any:

- recognised occupational retirement scheme; or
- mandatory provident fund scheme.

Both types of scheme fall within the definition of "recognised retirement scheme" under sec 2(1).