

Hong Kong Tax Alert

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Salaries Tax – Apportionment of Income for Double Taxation Relief

Summary

On 17 May 2022, the Court of Appeal (“CA”) handed down its decision on the case of *Commissioner of Inland Revenue v Lo Wa Ming Patrick* [2022] HKCA 710.

The decision provides guidance on the principles and approach to be used for the apportionment of income for the purpose of double taxation relief from Salaries Tax under section 8(1A)(c) of the Inland Revenue Ordinance (“IRO”). In this case, the Court found the formula below to be an appropriate approach for determining the amount of income to be excluded:

Excluded income = $\text{Income} \times \left[\frac{\text{Outside-Hong Kong}^1 \text{ working days} + \text{Leave days (including rest days and holidays) attributable to services rendered outside Hong Kong}^1}{\text{Calendar days}} \right]$

Notably, the Court’s suggested approach is arithmetically equivalent to a “workday” approach. In coming to its decision, the Court considered different approaches including, but ultimately ruling out, the Commissioner’s initial “Day in, Day out Formula” (DIDO Formula) based on physical presence in Hong Kong and the overseas location.

Going forward, the decision will impact double taxation relief claims where double taxation has been suffered in a jurisdiction which does not have a Double Taxation Agreement (“DTA”) with Hong Kong². Taxpayers should retain detailed travel records including rest and leave days to support claims.



Background

- The Taxpayer, Mr Lo, was employed by a Hong Kong company. He was seconded to work in Mainland China for a PRC entity between 1 August 2014 and 31 March 2015. Throughout the secondment period, Mr Lo remained employed by the employer.
- During the secondment period, Mr Lo returned to Hong Kong occasionally to perform services, which formed part of his work for the PRC entity.

¹ More specifically, this should be the territory outside Hong Kong which the taxpayer renders services and his/her employment income is subject to tax in that territory.

² From the year of assessment 2018/19, double taxation suffered in an DTA jurisdiction may be alleviated through a foreign tax credit under the DTA and Section 50(1) of the IRO.

- Under the terms of the secondment, Mr Lo was entitled to paid rest days on Saturdays, Sundays and Mainland public holidays, and to annual leave, which he spent in Hong Kong for personal reasons.
- Mr Lo's employment income during the secondment period was fully chargeable to Individual Income Tax in Mainland China and he paid tax in the Mainland.
- Mr Lo appealed against his 2014/15 Salaries Tax assessment and sought full exemption from Salaries Tax on his employment income during the secondment period.
- However, the Inland Revenue Department ("IRD") took the view that the quantum of income alleviated from double taxation should be determined by apportioning his income based on the number of days he spent in the Mainland each month over the total number of days in that month (the DIDO Formula). Since Mr Lo spent time outside the Mainland, his income during the secondment was not fully exempt from Salaries Tax.
- Mr Lo appealed to the Board of Review. The Board rejected the DIDO Formula and adopted a different formula (Board's Formula) for determining the quantum of relief. Broadly, the Board allowed an exclusion of income based on the number of days the taxpayer did not work in Hong Kong.
- The Commissioner appealed to the Court of First Instance ("CFI"). However, the CFI ruled in line with the Board. The present case is the Commissioner's appeal to the CA.

The Decision

The CA considered four different methods of time-based apportionment to determine the quantum of relief:

The Commissioner's primary position	Apportionment based on the number of days the taxpayer worked outside Hong Kong
The Board's Formula	Apportionment based on the number of days the taxpayer did not work in Hong Kong
DIDO Formula	Apportionment based on the number of days the taxpayer spent outside Hong Kong, whether working days or not
The Commissioner's alternative formula	Apportionment based on the number of days the taxpayer worked outside Hong Kong together with paid leave days attributable thereto

The CA accepted the Commissioner's alternative formula rejecting the other approaches. The CA noted that, subject to contractual provisions, there is no dispute that relief should be available for income for working days worked outside Hong Kong, and not for income for working days worked in Hong Kong. The issue is in relation to income for paid leave days. The CA considered that where income accrues on leave days which is attributable to services rendered outside Hong Kong, there is no reason why such leave pay should not qualify for relief from double taxation and be excluded if other conditions in section 8(1A)(c) of the IRO are satisfied.

The CA then remitted the case back to the Board for decision based on the below formula:

Excluded income = $\text{Income} \times [\text{Outside-Hong Kong working days} + \text{Leave days (including rest days and holidays) attributable to services rendered outside Hong Kong}] \div \text{Calendar days}$

The CA provided a numeric example. In the relevant year, the taxpayer had 200 working days – rendering services in Hong Kong for 80 days and rendering services outside Hong Kong for 120 days – and 165 leave days. The leave days prorated to services rendered outside Hong Kong may be calculated as $165 \times 120 \div 200 = 99$ days. The income that may qualify for exclusion under section 8(1A)(c) may be calculated as: $\text{annual income} \times (120 + 99) \div 365 = 60\%$ of annual income. This is arithmetically equivalent to prorating by reference only to working days (i.e., $120 \div 200$ which is also 60%).

Whilst the above broadly refers to days rendering services outside Hong Kong, this should only include days in a territory outside Hong Kong in which the taxpayer's employment income is subject to tax.

Notwithstanding the above, the CA mentioned it is a question of fact as to what income is derived from services rendered outside Hong Kong, and what leave days are attributable to services rendered outside Hong Kong.

Impact of this decision

Subject to contractual provisions, this decision provides guidance on the approach to calculate the quantum of relief from double taxation under section 8(1A)(c) of the IRO.

Taxpayers who qualify for relief from double taxation under section 8(1A)(c) should consider whether the CA's approach should be used to determine the quantum of relief. Taxpayers should retain records of working days and leave days.

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