

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D4/01

Personal assessment – personal assessment on his total income – section 42(1) of Inland Revenue Ordinance (‘IRO’).

Panel: Ronny Wong Fook Hum SC (chairman), Ronald Tong Wui Tung and Jason Yuen King Yuk.

Date of hearing: 4 November 2000.

Date of decision: 10 April 2001.

The taxpayer was the sole owner of Properties 1 and 6. The taxpayer’s wife was the sole owner of Property 5. The taxpayer and his wife were the co-owners of Properties 2, 4 and 7. The taxpayer and a third party were the co-owners of Property 3. It was the taxpayer’s case that the proviso of section 42(1) of the IRO does not prescribe that there must be income produced from a particular property in order for interest to be deducted.

The first issue is whether the interest paid by the wife in respect of Property 5 may be deducted from the net assessable values attributable to her, not only of Property 5, but also of Properties 2 and 4 for the year of assessment 1997/98 and Properties 2, 4 and 7 for the year of assessment 1998/99. The second issue is whether the interest paid by the wife in respect of Property 5 may be deducted from the net assessable values attributable to the taxpayer.

Held:

1. On the facts before them, the Board rejected the taxpayer’s claim. The Board rejected the taxpayer’s claim that the phrase ‘total income’ in the proviso of each of subsections (a) to (c) of section 42 allows a global deduction for interest payable against total taxable property income (D2/91, IRBRD, vol 5, 532 considered; D50/96, IRBRD, vol 11, 547 and D86/99, IRBRD, vol 14, 581 applied).
2. The Board thinks that there is no inaccuracy in paraphrasing section 42(1) of the IRO ‘that part of the total income arising from paragraph (a)’ to ‘that part of the total taxable property income’. By referring to ‘that part of the total income arising from paragraphs (a) and (d)’, the legislature intended that there should be some correlation between the interest claimed and the income relieved (D86/99, IRBRD, vol 5, 532 followed).

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Appeal dismissed.

Cases referred to:

- D2/91, IRBRD, vol 5, 532
- D50/96, IRBRD, vol 11, 547
- D86/99, IRBRD, vol 14, 581

Wong Ki Fong for the Commissioner of Inland Revenue.
Stanley So Kai Tong of Messrs Stanley So & Co for the taxpayer.

Decision:

The relevant provisions in the IRO

1. Section 5 in Part II of the IRO provides that:

'(1) Property tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person being the owner of any land or buildings ... wherever situate in Hong Kong and shall be computed at the standard rate on the net assessable value of such land or buildings ... for each such year.

...

(1A) In subsection (1), "net assessable value" means the assessable value of land or buildings ... ascertained in accordance with section 5B –

(a)

(b) less –

(i) where the owner agrees to pay the rates in respect of the land or buildings ... those rates paid by him; and

(ii) an allowance for repairs and outgoings of 20% of that assessable value after deduction of any rates under subparagraph (i).'

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2. Section 5B in Part II of the IRO provides:

- ‘ (1) *This section shall apply to any year of assessment commencing on or after 1 April 1983.*
- (2) *The assessable value of land or buildings ... for each year of assessment shall be the consideration, in money or money’s worth, payable in that year to ... the owner in respect of the right of use of that land or buildings ...’.*

3. Section 41 in Part VII of the IRO provides:

- ‘(1) *Subject to subsection (1A), individual –*
- (a) *of or above the age of 18 years, or under that age if both his or her parents are dead; and*
- (b) *who is or, if he or she is married, whose spouse is either a permanent or temporary resident,*
- may elect for personal assessment on his or her total income in accordance with this Part.*
- (1A) *Where –*
- (a) *an individual is married and not living apart from his or her spouse; and*
- (b) *both that individual and his or her spouse –*
- (i) *have income assessable under this Ordinance; and*
- (ii) *are eligible to make an election under subsection (1),*
- then that individual may not make such an election unless his or her spouse does so too.’*

4. Section 42 in Part VII of the IRO provides :

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(1) *For the purposes of this Part the total income of an individual for any year of assessment shall, subject to subsection (8), be the aggregate of the following amounts –*

(a) (i) ...

(ii) *in respect of the years of assessment commencing on or after 1 April 1983, the sum equivalent to the net assessable value as ascertained in accordance with sections 5(1A) and 5B:*

Provided that where an individual is a joint owner or co-owner of property, that individual's share of net assessable value shall be computed by apportioning the value ascertained in accordance with section 5(1A) or 5B –

(a) *in the case of joint ownership, between the joint owners equally; and*

(b) *in the case of ownership in common, between the owners in common each in proportion to his share in such ownership;*

(b) *the net assessable income of the individual for that year of assessment; and*

(c) *subject to subsection (1A), the assessable profits of the individual for that year of assessment computed in accordance with Part IV:*

(d) *(Repealed 17 of 1989 s. 10)*

Provided that there shall be deducted from that part of the total income arising from paragraph (a) the amount of any interest payable on any money borrowed for the purpose of producing that part of the total income where the amount of such interest has not been allowed and deducted under Part IV.'

(2)-(9) ...

(10) *Where an election is made by a husband and wife under section 41(1A) the total income (as reduced under subsections (2) and (5)) of each of*

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them shall be separately calculated under this section before both incomes are aggregated under section 42A.'

5. Section 42A in Part VII of the IRO provides:

(1) In giving effect to an election under section 41 the assessor shall make a single assessment –

(a) in the sum of the total income, as reduced under section 42(2) and (5), of the individual making the election; or

(b) in the case of an election under section 41(1A), in the sum of the joint total income resulting from the aggregation of the total income of the one spouse, as so reduced, with that of the other, as also so reduced,

as reduced in each case by such of the allowances prescribed in Part V as may be appropriate.'

Background

6. Seven properties are involved in this case. They are:

- (a) Property 1;
- (b) Property 2;
- (c) Property 3;
- (d) Property 4;
- (e) Property 5;
- (f) Property 6; and
- (g) Property 7.

7. We are concerned with two years of assessment: 1997/98 and 1998/99. In those two years of assessment:

- (a) The Taxpayer was the sole owner of Property 1 and Property 6.

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- (i) The assessable value of Property 1 ascertained in accordance with section 5B of the IRO is \$216,000. The net assessable value of Property 1 arrived at in accordance with section 5(1A) of the IRO is \$172,800 (80% of \$216,000).
 - (ii) Property 6 was left vacant in the year of assessment 1997/98. It was occupied by the Taxpayer in the year of assessment 1998/99.
- (b) The Taxpayer's wife ('the Wife') was the sole owner of Property 5.
 - (i) There is no assessable value in respect of that property for the year of assessment 1997/98. The Wife however paid interest of \$302,444 to the finance company, Company A in respect of facilities secured by this property for the period between April 1997 and March 1998.
 - (ii) In respect of the year of assessment 1998/99, the Wife declared that Property 5 was let for the period from August 1998 to March 1999. The assessable value for that year of assessment is \$263,237 and the net assessable value is \$210,589 (80% of \$263,237). For the period between April 1998 and July 1998, the Wife paid \$106,728 by way of interest to Company A. For the period between August 1998 and March 1999, the Wife paid \$201,713 by way of interest to that finance company.
- (c) The Taxpayer and his Wife were the co-owners of the following properties:
 - (i) Property 2: In respect of the years of assessment 1997/98 and 1998/99, the Taxpayer's share of the net assessable value of this property apportioned in accordance with section 42(1)(a) is \$72,000. The Wife's share of the net assessable value is the same.
 - (ii) Property 4: In respect of the year of assessment 1997/98, the Taxpayer's share of the net assessable value of this property apportioned in accordance with section 42(1)(a) is \$166,982. The Wife's share of the net assessable value is the same. Mortgage interest totalling \$278,954 was paid in relation to facilities extended by Bank B and secured by this property. The respective share of mortgage interest of the Taxpayer and the Wife is \$139,477. In respect of the year of assessment 1998/99, the Taxpayer's share of net assessable value of this property apportioned in accordance with section 42(1)(a) is \$179,443 whilst the Wife's share of the

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same is \$179,442. Their respective share of the interest paid is \$142,537.

- (iii) Property 7: This property is only relevant for the year of assessment 1998/99. The respective share of the net assessable value of the Taxpayer and his Wife apportioned in accordance with section 42(1)(a) is \$168,000 each. Mortgage interest totalling \$287,353 was paid in favour of Bank C. The respective share of the Taxpayer and his Wife is \$143,676 and \$143,677.
- (d) The Taxpayer and a third party were the co-owners of Property 3. For the years of assessment 1997/98 and 1998/99, the Taxpayer's share of the net assessable value of this property apportioned in accordance with section 42(1)(a) is \$72,000.

8. In respect of the year of assessment 1997/98, the positions of the Taxpayer and his Wife may be summarised as follows:

Position of	Property	Net assessable value \$	Interest paid and claimed \$	Difference between net assessable value and interest paid \$
The Wife				
	2	72,000		72,000
	4	166,982	139,477	27,505
	5		302,444	
	[Sub-totals]	238,982	441,921	99,505
The Taxpayer				
	1	172,800		172,800
	2	72,000		72,000
	3	72,000		72,000
	4	166,982	139,477	27,505
	[Sub-totals]	483,782	139,477	344,305

9. In respect of the year of assessment 1998/99, the positions of the Taxpayer and his Wife may be summarised as follows:

Position of	Property	Net assessable value \$	Interest paid and claimed \$	Difference between net assessable value
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				and interest paid \$
The Wife				
	2	72,000		72,000
	4	179,442	142,537	36,905
	5		\$106,728 for the period between April 1998 and July 1998	
		\$210,589 being the net assessable value for the period between August 1998 and March 1999	\$201,713 for the period between August 1998 and March 1999	8,876
	7	168,000	143,677	24,323
	[Sub-totals]	630,031	594,655	142,104
The Taxpayer				
	1	172,800		172,800
	2	72,000		72,000
	3	72,000		72,000
	4	179,443	142,537	36,906
	7	168,000	143,676	24,324
	[Sub-totals]	664,243	286,213	378,030

10. In the two years of assessment, the Taxpayer earned \$960,000 by way of salary in each year of assessment. His Wife did not have any salary income. Both the Taxpayer and his Wife did not have any assessable profits in the two years of assessment.

11. At the conclusion of the oral hearing before us on 4 November 2000, the issues on the basis of the facts summarised above are:

- (a) Whether the interest paid by the Wife in respect of Property 5 may be deducted from the net assessable values attributable to her, not only of Property 5, but also of Properties 2 and 4 for the year of assessment 1997/98 and Properties 2, 4 and 7 for the year of assessment 1998/99.
- (b) Whether the interest paid by the Wife in respect of Property 5 may be deducted from the net assessable values attributable to the Taxpayer.

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12. Mr Stanley So (‘ Mr So’), the Taxpayer’s tax representative, was not fully equipped to argue these legal issues before us. In view of the general importance of this appeal, we gave the Taxpayer leave to file a written submission on the legal issues raised by 25 November 2000. After a short extension of time, Mr So filed his written submission on 8 December 2000. It is a matter of regret that he did not confine himself to the legal issues but sought to introduce for the first time fresh evidence not canvassed at the hearing before us. He also requested the Board to reconvene for the purpose of hearing such fresh evidence. The Revenue urged us not to receive such evidence and further countered by inviting us to re-compute the relevant figures afresh. We deprecate the manner whereby this appeal was conducted on behalf of the Taxpayer. No reason has been advanced on behalf of the Taxpayer as to why the fresh evidence was not adduced on 4 November 2000. We are not prepared to entertain his belated request. We would decide this appeal on the basis of the facts outlined above.

Arguments of the Taxpayer

13. The phrase ‘ total income’ in the proviso should mean the total of each of sub-sections (a) to (c) of section 42.

14. The proviso does not prescribe that there must be income produced from a particular property in order for interest to be deducted.

15. The proviso allows a global deduction for interest payable against total taxable property income.

16. Reliance is placed on pages 227 to 228 of David Flux’s Hong Kong Taxation – Law and Practice 1983-84 edition.

Arguments of the Revenue

17. Where an individual who elects for personal assessment on his total income in accordance with Part VII has a single property chargeable to property tax and the interest payable on money borrowed for the purpose of producing the net assessable value of that property exceeds the net assessable value of that property, the proviso to section 42(1) restricts deduction of the interest to the amount of the net assessable value of that property.

18. There is no provision allowing the excess to be carried forward and set off against the net assessable value of that property in subsequent years of assessment.

19. The deduction envisaged by the proviso is only against the amount of net assessable value in (a). There is no provision permitting the excess to be set off against:

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- (a) the net assessable income or
- (b) the assessable profits.

The use of the word ‘aggregate’ precludes the recognition of a ‘negative net assessable value’ under the IRO.

20. For years of assessment commencing on or after 1 April 1983, section 42(1)(a)(ii) provides that the amount to be aggregated is the sum equivalent to the net assessable value as ascertained in accordance with sections 5(1A) and 5B of the IRO. The net assessable value as ascertained in accordance with sections 5(1A) and 5B is determined with reference to each individual property. Where the net assessable value as ascertained in accordance with sections 5(1A) and 5B of the IRO is determined with reference to each individual property, the phrase ‘that part of the total income arising from paragraph (a)’ in the proviso to section 42(1) should also be applied with respect to each individual property.

21. Section 42(1) proviso should be applied individually to each property and the ceiling for interest deduction is the net assessable value of each individual property concerned.

22. If an individual does not have any net assessable value arising from his wife’s property, then there is no question of the individual having any deduction of the interest in relation to his wife’s property under the proviso to section 42(1) against his total income.

23. As their ‘fallback position’, the Revenue submits:

- (a) the phrases ‘the part of the total income arising from paragraph (a)’ and ‘that part of the total income’ in the proviso to section 42(1) of the IRO should mean the same thing, that is, the net assessable value as ascertained in accordance with sections 5(1A) and 5B of the IRO.
- (b) Interest is deductible under the proviso to section 42(1) only to the extent of the global total net assessable value of all let properties as ascertained in accordance with sections 5(1A) and 5B of the IRO. In no case could the interest under the proviso be deducted from the net assessable income or the assessable profits of an individual.

The state of the authorities

24. As indicated above, the Taxpayer placed considerable reliance on David Flux’s Hong Kong Taxation – Law and Practice 1983-84 Edition where the Learned Author, after setting out the four constituents for ‘total income’ under the then legislation, stated as follows:

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‘From the aggregate so obtained, the following are then deductible:

1. *Interest payable on money borrowed for the purpose of producing any of the income under (1) and (4) so long as that interest has not already been deducted under one of the heads (1) to (4) (Section 42(1) proviso). This would particularly include interest on money borrowed to purchase, improve or repair let property which is not deductible for Property Tax, and interest on money borrowed to invest in securities giving rise to taxable interest income. Any money borrowed for a business subject to Profits Tax is likely to have already given rise to allowable interest which will not therefore be deductible again under this head. The total interest which is relievably under this heading is the aggregate of the income under heads (1) and (4) even if the interest was incurred in producing income under only one of those heads.’*

25. This citation from the out-of-date edition of Mr David Flux’s book is grossly misleading. At page 416 of Flux & Smith’s Hong Kong Taxation Law and Practice 2000-1 edition, the Learned Authors stated the current position as follows:

‘More specifically, the total income is the aggregate of the following items:

- (1) *the person’s share of the net assessable value of any income subject to Property Tax ...*
- (2) *net assessable income ... for Salaries Tax purposes ...; plus*
- (3) *Profits assessable to Profits Tax, after the deduction of losses brought forward ...*

From the aggregate so obtained, the following is then deducted:

- (4) *interest payable on money borrowed for the purpose of producing income included head (1) above, provided that the interest has not already been deducted in calculating the person’s assessable profits for Profits Tax purposes (Sec. 42(1) proviso). This would cover interest on any money borrowed to purchase, improve or repair let property, the income from which is subject to Property Tax. It is important to note that such amounts would not normally be deductible under the Property Tax provisions and, therefore, the availability of this deduction is an important encouragement for individuals to elect for Personal Assessment where they own rent producing property. The interest deductible under this provision is limited to the total income*

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included under item (1) above; any excess interest cannot be offset against other income incorporated in the Personal Assessment calculation and cannot be carried forward ...'

26. In D2/91, IRBRD, vol 5, 532, the taxpayer exchanged a property of his with a property of his mother. The former property was subject to a mortgage. In order to effect the exchange it had been necessary for the taxpayer to repay the mortgage and to achieve this he mortgaged the property which he was acquiring. The loan which he obtained on the property which he was acquiring was greater than what was necessary to redeem the mortgage on his former property. The Board of Review allowed the taxpayer's claim to the extent of what was necessary to redeem that mortgage. The Board of Review indicated that:

'In the course of the hearing we indicated to the representative for the Commissioner that the words in the proviso of section 42(1) which state that interest shall be deducted from "that part of the total income arising from paragraph (a)" relates to the aggregate of all the rental income and that if the rental income of a property were less than the amount of interest capable of being deducted, the balance of the interest could be deducted against the rental income from another property. On the facts before us this question does not arise because the balance of the interest in this case has not been claimed by the Taxpayer in the course of the hearing before us to be attributable to the production of rental income. Accordingly we make no ruling in this regard.'

Whilst we recognise that these significant observations by the Board of Review were not part of the *ratio* in that case, we do consider them with the utmost respect.

27. In D50/96, IRBRD, vol 11, 547, the taxpayers owned three properties. Property A was rented out at all times. Property B was once the family residence. In order to provide sufficient living area for the family, the taxpayers acquired Property C. That acquisition was financed by the mortgage of Properties B and C. The Board there stated that:

'The proviso to section 42(1) allows the deduction under personal assessment on money borrowed for the purpose of producing income chargeable to property tax. To succeed in their claim, the Taxpayers need to establish:

- (1) that interest was payable;*
- (2) that the interest was payable on money borrowed; and*
- (3) that the money was borrowed for the purpose of producing chargeable property income.*

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The first two conditions are clearly satisfied in this case. The only issue for us to decide is whether the money on which the interest was paid was borrowed for the purpose of producing income chargeable to property tax.'

On the facts before them, the Board of Review rejected the taxpayers' claim.

Mr So pointed out that the Board did not lay down a fourth condition, namely, that chargeable property income was in fact produced, as a pre-requisite for deduction. We do not find force in this submission as the issue in that case relates to the 'purpose' of the 'money borrowed' and the propositions were stated in the light of that issue.

28. In D86/99, IRBRD, vol 14, 581 the taxpayer purchased the Property in March 1997 for long-term investment to generate rental income. The purchase was financed by way of a mortgage. During the year of assessment 1997/98, the taxpayer received no rental income from the Property but he paid total mortgage interest of \$207,321. The taxpayer owned two other properties during the same year of assessment. Both were let fully furnished and produced rental income. The taxpayer sought to deduct the mortgage interest in respect of the Property against the rental income from the other two properties. The taxpayer 'contended that the proviso to section 42(1) does not specify that one can only look at the separate rental income for each individual property; rather it specifies the total income of an individual for any year of assessment' – an argument similar to the one deployed by the Taxpayer in this case. The Board of Review rejected that argument and pointed out that:

' The proviso to section 42(1)

5. *The Taxpayer argues, correctly, that an individual's total taxable income is aggregated for personal assessment purposes. But it does not follow that his total interest expenses should then be deducted against his total income. Rather, under personal assessment, to qualify for a deduction interest payable must satisfy the applicable statutory provisions, namely, either the proviso to section 42(1) ...*

6. *The proviso to section 42(1) allows a deduction from :*

“ that part of the total income arising from paragraph (a) [paragraph (a) speaks of net assessable value for property tax purposes] the amount of any interest payable on any money borrowed for the purpose of producing that part of the total income where the amount of such interest has not been allowed and deducted [under the provisions relating to profits tax].” (emphasis added)

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7. *By its express terms the proviso only allows a deduction for interest payable on money borrowed for the purpose of producing that part of the total taxable property income which has been included for personal assessment under paragraph (a) for the relevant year of assessment. It does not allow a global deduction for interest payable against total taxable property income; even less does it allow a global deduction for interest payable against the total taxable income.*
8. ...
9. *We conclude that in the year of assessment 1997/98 the Taxpayer did not derive any taxable income from Property 1. Therefore, whatever interpretation is placed upon the phrase “that part” in the proviso to section 42(1), the interest paid by the Taxpayer to Bank B on Property 1 mortgage in the year of assessment 1997/98 cannot be deducted under that provision. Simply put, in the year of assessment 1997/98 the money borrowed did not produce any – or any part – of the taxable property income assessed to the Taxpayer under section 42(1)(a).’*

29. D86/99 is directly in point. Mr So mounted a two pronged challenge against this decision. First, it is said that the proviso referred to ‘that part of the total income arising from paragraph (a)’ and that the Board of Review ‘cannot be said to be 100% accurate’ when they referred to ‘the total taxable property income’. Secondly, our attention was drawn to section 42 in the 1975 edition of the IRO which referred to deduction ‘from that part of the total income arising from paragraphs (a) [the net assessable value] and (d) [interest chargeable to interest tax] the amount of any interest payable on any money borrowed for the purpose of producing that part of the total income ...’. Mr So contended that the old proviso envisaged deduction from a category of income and amendments arising from abolition of interest tax should make no difference to this construction.

30. We are of the view that the Board in D86/99 was most careful in their choice of language. We do not think there is any inaccuracy in paraphrasing ‘that part of the total income arising from paragraph (a)’ to ‘that part of the total taxable property income’. As far as the old proviso is concerned, we are of the view that Mr So’s argument gives insufficient weight to the words ‘that part of the total income’ when they first appear in the proviso. If Mr So be right, it would have been sufficient for the proviso to read ‘Provided that there shall be deducted from income arising from paragraphs (a) and (d) the amount of any interest payable on any money borrowed for the purpose of producing that part of the total income’. By referring to ‘that part of the total income arising from paragraphs (a) and (d)’, the legislature intended that there should be some correlation between the interest claimed and the income relieved. There is therefore no justification for us to depart from the decision of the Board in D86/99.

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31. For these reasons, we dismiss the Taxpayer' s appeal and direct that he should be assessed on the basis of the figures set out in this decision and in the light of our rulings. We give the parties liberty to apply if there be disagreement in the working out of our order.