

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D51/04

Property tax – section 42(1) of the Inland Revenue Ordinance – whether a global deduction of interest payable against the total taxable property income.

Panel: Anna Chow Suk Han (chairman), Peter R Griffiths and Paul Mok Yun Lee.

Date of hearing: 31 August 2004.

Date of decision: 28 September 2004.

The taxpayer and his wife were joint owner of Property 1, Property 2 and Property 3. They took out the first loan to finance the purchase of Property 1. Subsequently, they took out the second loan and by using the funds from the second loan and other sources, they partially repaid the first loan. Property 1 and Property 2 were let out for rental income.

In the tax return, the taxpayer claimed a deduction of the taxpayer's share of interest payment to produce his share of the rental income from Property 1 and Property 2. The assessor considered that the interest incurred by the taxpayer in relation to the said property should only be allowed to the extent of the taxpayer's share of the net assessable value of the said property. Accordingly the assessor raised an additional personal assessment.

The taxpayer's grounds of appeal are mainly that the assessor had mistaken the loan as a re-mortgage loan and the assessor was wrong to make a deduction of the amount of net assessable value of the property rather than the amount of interest payments of the property. He claimed that this practice of deduction was not adopted by the Revenue.

Held:

1. The proviso to section 42(1) allows a deduction from that part of the total taxable property income, that is the net assessable value of the properties the amount of interest payable on a loan made for the purpose of producing that part of the total taxable property income. The key words in the proviso affecting the taxpayer's case are 'that part' which negate a global deduction of interest payable against the total taxable property income.
2. Since the amount of interests paid by the taxpayer on the First Loan and the Second Loan was greater than the amount of the net assessable value of Property

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1 and by reason of the words ‘that part’ in the proviso to section 42(1), a deduction of interest payment in respect of Property 1 can only be allowed to the extent of the net assessable value of Property 1 and the excess cannot be deducted from the net assessable value of Property 2 (D86/99, IRBRD, vol 14, 581; D4/01, IRBRD, vol 16, 126; and D96/01, IRBRD, vol 16, 796 followed).

Appeal dismissed.

Cases referred to:

D86/99, IRBRD, vol 14, 581
D4/01, IRBRD, vol 16, 126
D96/01, IRBRD, vol 16, 796

Chan Siu Ying for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The appeal

1. Mr X (‘the Taxpayer’) has appealed against the Commissioner’s determination on the additional personal assessment for the year of assessment 2002/03 raised on him. The Taxpayer claims that the interest expense should be fully allowed to set-off against the total property income in computing his tax liability under personal assessment.

2. The facts of this case are simple and straight forward. They are as set out in the Commissioner’s determination of 30 April 2004. The Taxpayer gave no further evidence at the hearing. He confirmed that save for the statement about the interest on the loan of \$650,000 from Credit Company Y, the facts stated in the Commissioner’s determination were correct. The salient facts are as below.

3. At the relevant times, the Taxpayer and his wife (‘the Couple’) were the joint owners of the properties, namely:

- (1) ‘Property 1’;
- (2) ‘Property 2’; and

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(3) 'Property 3'.

4. On the security of Property 1, the Couple took out a mortgage loan of \$3,535,000 from Credit Company Z ('the First Loan') to finance the purchase of Property 1.

5. Subsequently, also on the security of Property 1 the Couple took out a further loan of \$650,000 ('the Second Loan') from Credit Company Y. By using the funds from the Second Loan and other sources totally \$900,000, the Couple partially repaid the First Loan.

6. The Couple paid the following interests in respect of the First Loan and the Second Loan during the period from 1 April 2002 to 31 March 2003:

The First Loan	\$111,787.94
The Second Loan	<u>\$21,613.96</u>
	<u>\$133,401.90</u>

7. During the assessment year 2002/03, Property 1 and Property 2 were let out by the Couple for rental income. The net assessment values of the properties were as follows:

Property	Net assessable value	The Taxpayer's share	His wife's share
1	\$99,374	\$49,687	\$49,687
2	<u>\$236,478</u>	<u>\$118,239</u>	<u>\$118,239</u>
	<u>\$335,852</u>	<u>\$167,926</u>	<u>\$167,926</u>

8. In his tax return for the assessment year 2002/03, the Taxpayer claimed a deduction of the following interest payments to produce his share of the rental income from Property 1 and Property 2:

Property 1 \$133,401 x 50%	\$66,701
Property 2	<u>\$89,468</u>
	<u>\$156,169</u>

9. On 6 January 2004, the assessor raised on the Taxpayer personal assessment for the assessment year 2002/03, allowing a deduction of the interest payments as claimed by the Taxpayer. However, upon review the assessor considered that the interest incurred by the Taxpayer and his wife in relation to Property 1 should only be allowed to the extent of its net assessable value. Accordingly, the assessor raised on the Taxpayer an additional personal assessment for the year of assessment 2002/03. The following notes were quoted in the additional assessment :

' 1. Interest on re-mortgage loan is disallowed.

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2. Interest deduction is limited to the net assessable value of individual property.’

10. The Taxpayer objected to the additional assessment because the assessor quoting the note that ‘interest on re-mortgage loan is disallowed’ was wrong since not only the additional loan of Property 1 did not increase the size of the loan of Property 1 but it also reduced the amount of interest payments.

11. However, by a letter dated 15 March 2004, the assessor informed the Taxpayer that the said note on ‘interest on re-mortgage loan’ was wrongly quoted and explained that a deduction of interest on mortgage loan was restricted to the net assessable value of an individual property under the proviso to section 42(1) of the Inland Revenue Ordinance (‘IRO’) and invited the Taxpayer to withdraw the objection.

12. The Taxpayer declined to withdraw the objection and filed a notice of appeal. His grounds of appeal are mainly that the assessor had mistaken the loan from Credit Company Y as a re-mortgage loan and the assessor was wrong to make a deduction of the amount of net assessable value of the property rather than the amount of interest payments of the property. He claimed that this practice of deduction was not adopted by the Revenue before.

13. The Revenue produced the Board of Review Decision D86/99, IRBRD, vol 14, 581, D4/01, IRBRD, vol 16, 126 and D96/01, IRBRD, vol 16, 796 in support of its case. The Revenue’s case is that on the interpretation of the proviso to section 42(1) of the IRO, differently constituted Board of Review held that the proviso to section 42(1) did not allow a global deduction for interest payable against total taxable property income. The amount of interest deductible had to be restricted to the net assessable value of that property. There should be some correlation between the interest claimed and the income relieved. Accordingly, the amount of interest in respect of Property 1 deductible for personal assessment was \$99,374, that is, an amount equal to the net assessable value of Property 1 included in the total income of the Taxpayer. As to the assessor’s note ‘interest on re-mortgage loan is disallowed’, it was mistakenly quoted and is not applicable to the Taxpayer’s case. The additional assessment is raised not by reason of discounting the interest payment in respect of the Second Loan.

14. Section 42(1) of the IRO reads as follows:

‘(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) ...

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- (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 ...*
- (b) *the net assessable income of the individual for that year of assessment; and*
- (c) *... the assessable profits of the individual for that year of assessment computed in accordance with (Profits Tax);*
- (d) *...*

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 (Profits Tax).’ (emphasis added)

Our decision

15. We understand from the Taxpayer that he is one of those victims who suffered severe losses in the depressed property market as a result of the economic downturn in Hong Kong after 1997. He and his wife acquired Property 1 at the height of the property market, requiring to pay interest at a high rate but receiving rental income at a reduced amount. He feels aggrieved by the fact that he cannot claim a deduction of the total interest payments in respect of Property 1 against his total property income. He claimed that this practice of non-deduction of the entire amount of interest payments was not previously adopted by the Revenue. He is also of the view that the Board decisions produced by the Revenue were distinguishable from his case because rental income was not collected in the relevant year of assessment in those cases.

16. While we sympathize with the Taxpayer in his plights, we also have a duty to apply the law as enacted. The relevant law in this connection is the proviso to section 42(1). The proviso allows a deduction from that part of the total taxable property income, that is, the net assessable value of the properties the amount of interest payable on a loan made for the purpose of producing that part of the total taxable property income. The key words in the proviso affecting the Taxpayer’s case are ‘that part’ which negate a global deduction of interest payable against the total taxable property income. Since the amount of interests paid by the Taxpayer on the First Loan and the Second Loan was greater than the amount of the net assessable value of Property 1 and by reason of the words ‘that part’ in the proviso to section 42(1), a deduction of interest payment in respect of Property 1 can only be allowed to the extent of the net assessable value of Property 1 and the excess cannot be deducted from the net assessable value of Property 2. It is important that the Taxpayer should understand that the additional assessment was raised not because the Revenue has mistaken that the interest arose from a re-mortgage of Property 1 but because of the proviso to

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section 42(1) which prohibits a global deduction of interest payable against the total taxable property income. As to the Taxpayer's contention that the Revenue had previously not adopted this practice of non-deduction of interest, we believe the Revenue has never departed from the law in this regard. As pointed out by the Revenue, the Taxpayer was similarly treated by the Revenue in respect of interest deductions relating to Property 1 and the Taxpayer's other properties in previous assessment years.

17. Furthermore, we would like to add that the Board decisions cited by the Revenue are relevant to the issue in this proceedings. Those decisions also involve deductions of interest against total taxable property income. We are unable to find any reasons for us not to follow those authorities.

18. Accordingly, we dismiss the Taxpayer's appeal and confirm the additional assessment.