INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D86/99

Personal Assessment Tax – deduction for mortgage interest – sections 42(1) and 42(2)(b) of the Inland Revenue Ordinance.

Panel: Andrew Halkyard (chairman), Brian Hamilton Renwick and Anthony So Chun Kung.

Date of hearing: 7 October 1999.
Date of decision: 4 November 1999.

The taxpayer purchased Property 1 in March 1997 for long-term investment to generate rental income. The purchase was financed by way of a mortgage. On 10 March 1998 the taxpayer was notified that Property 1 was ready for occupation on 26 March 1998. He immediately set about trying to rent Property 1 out. A provisional tenancy agreement was signed on 14 March 1998. The tenant was allowed to take possession on 28 March 1998 and was granted a rent-free period until 31 March 1998. On 1 April 1998 a formal agreement for the lease of Property 1 in a furnished state was signed for a term of two years commencing from 1 April 1998. In relation to Property 1, the taxpayer received no rental income prior to 1 April 1998 but during the year ended 31 March 1998 paid total mortgage interest of $207,321.

During the year of assessment 1997/98 the taxpayer owned two other properties. They were both let fully furnished and produced rental income. At all relevant times the taxpayer had not taken out any business registration certificate nor did he hire any employee to assist him in relation to his letting activities.

The assessor disallowed the taxpayer' s claim to deduct under his personal assessment for the year of assessment 1997/98 the interest paid by him in that year for his mortgage of Property 1. The Commissioner upheld the assessor' s refusal. The taxpayer appealed.

Held, dismissing the appeal:

(1) By its express term the proviso to section 42(1) 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 taxable income. In the year of assessment

1997/98 the taxpayer did not derive any taxable income from Property 1. Therefore the mortgage interest paid by the taxpayer on Property 1 in that year cannot be deducted under section 42(1).

(2) To be eligible under personal assessment to claim the disputed amount as a deduction from total income under section 42(2), the taxpayer must show that his activities in relation to his rented properties could properly be described as carrying on business.

(3) The analogy between a company and an individual is not appropriate. Not only is there a 'practical difference' between the actions of an individual and that of a company 'whose sole raison d'être is ... the conduct of a trade or business' (see Lam Woo-shang v CIR (1961) 1 HKTC 123 at 149 per Hogan CJ) but, more importantly, a company that lets property is deemed to carry on business whereas an individual who lets property, as distinct from sub-lets property, is not deemed to carry on business (see definition of 'business' in section 2(1)).

(4) It is true that in many areas of taxation law the threshold for carrying on business is very low and easily satisfied. However, in the case of individual leasing premises, even though the premises were furnished and maintained and supervised by that individual, it has been decided in the Superior Courts of Hong Kong that the threshold is relatively high and not easily satisfied. The taxpayer acted no differently from any ordinary landlord seeking to turn his property to account in the normal way by letting it out at the best rent (Lam Woo-shang v CIR was considered and applied).

(5) Even if we were to find that the taxpayer did carry on a property letting business in the year of assessment 1997/98, the interest payments prior to the issue of the occupation permit for Property 1 could not have been deducted. A recent case, Wharf Properties Ltd v CIR [1997] 1 HKC 184; [1997] STC 351, would bind us to conclude that interest expenses incurred on the provision of land and buildings used by a taxpayer as a capital asset in its business must be capitalised (and not immediately deducted) if incurred prior to the issue of the occupation permit.

Per Curiam:

We see the force of the taxpayer's arguments if taxation were based upon economic concepts rather than the force of the law. However, it is trite, but true, that taxation is not always fair. We must apply the law as enacted and as interpreted by courts whose decisions bind us.

Appeal dismissed.

Cases referred to:

Lam Woo-shang v CIR (1961) HKTC 123
Wharf Properties Ltd v CIR [1997] 1 HKC 184; (1997) STC 351

Leung Wing Chi for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. The Taxpayer has appealed against the Commissioner' s determination of personal assessment tax for the year of assessment 1997/98. He claims that under the proviso to section 42(1) and under section 42(2)(b) of the Inland Revenue Ordinance he should be granted a deduction for mortgage interest he incurred in relation to a flat located in District A (' Property 1').

The facts

2. The basic facts, which we so find, are not in dispute. They are set out at pages 1 to 3 of the Commissioner' s determination.

3. During the course of the hearing the Taxpayer elected to give sworn oral evidence. We find him to be a competent witness. On the basis of his evidence, and the documents provided to us by both parties, we find the following additional fact:

1. The Taxpayer purchased Property 1 on 27 March 1997 for $3,882,000. It was purchased for long-term investment to generate rental income.

2. Property 1 was purchased when still under construction. The property was expected to be completed towards the end of November 1997. Construction was delayed by inclement weather. On 10 March 1998 the Taxpayer' s solicitor notified him that Property 1 was ready for occupation and that he must complete the assignment on or before 26 March 1998. This he did.

3. After being notified by the solicitor the Taxpayer immediately set about trying to rent Property 1. He advertised the property for rental, he contacted various real estate agents and showed the property to prospective tenants. In the event, a provisional tenancy agreement was signed on 14 March 1998. Amongst other things, that agreement stated that the formal agreement for lease of the property

must be signed on or before 1 April 1998, the delivery date of the property was 28 March 1998 and the property was to be let in a furnished state.

4. Before the tenant occupied Property 1 the Taxpayer arranged with the developer to rectify certain defects and carry out certain repairs. He arranged for the property to be painted and the floor to be polished. He installed various fixtures such as cupboards. He arranged for light fittings and curtains. He purchased furniture for the property including beds, sofa, table and chairs as well as appliances such as air conditioners, television, refrigerator, washing machine and stove. All these works were completed by 28 March 1998.

5. The tenant of Property 1 was allowed to take possession on 28 March 1998. The Taxpayer granted the tenant a rent-free period until 31 March 1998 to enable the tenant to move her personal belongings into the property.

6. The formal agreement for the lease of Property 1 was signed on 1 April 1998. The term of the lease was ' two years commencing from 1 April 1998 to 31 March 2000' . The rent was $11,800 per month. The Taxpayer received no rental income in relation to Property 1 prior to 1 April 1998.

7. The Taxpayer financed the purchase of Property 1 by way of a mortgage obtained from Bank B, in the amount of $2,717,400. The mortgage was for a term of 25 years. The first monthly interest payment was made on 3 June 1997. During the year ended 31 March 1998 the Taxpayer paid total interest on this mortgage of $207,321.

8. During the year of assessment 1997/98 the Taxpayer owned two other properties. They were located in District C (' Property 2') and District D (' Property 3'). They were both let and produced rental income. Property 2 was let since 1993. Property 3 was let since 1992. For the year of assessment 1997/98 the Taxpayer derived rental income from these two properties of $224,172.

9. During the year of assessment 1997/98 Property 3 was not subject to any mortgage. During this year Property 2 was mortgaged to the Bank E and the Taxpayer paid interest thereon of $59,425.

10. The tenant of Property 1 paid all utilities charges. However, the Taxpayer arranged for the initial provision of the utilities (including payment of the deposit for installation). He also maintained the property and, where necessary, arranged for the repair of fixtures and fittings.

11. All the Taxpayer' s three rental properties, including Property 1, were let fully furnished. The Taxpayer believes that furnishing his properties provides better conditions for attracting long-term tenants.

12. At all relevant times the Taxpayer had not taken out any business registration certificate.

13. For each of his three rental properties, the Taxpayer kept a separate bank account to keep track of the respective tenant' s rental payments. However, all payments made by him in relation to the properties, such as rates, management fees and property tax, were paid from his current account which allowed him a seven-day interest-free overdraft facility.

14. The Taxpayer kept books and records to keep track of his letting activities. The extent of those books and records was not disclosed to us.

15. The Taxpayer did not hire any employee to assist him in relation to his letting activities.

16. The assessor disallowed the Taxpayer' s claim to deduct under his personal assessment for the year of assessment 1997/98 the interest paid by him in that year for his mortgage of Property 1 (fact 7 refers).

17. The Commissioner upheld the assessor' s refusal to allow the deduction.

18. The Taxpayer has now lodged a valid appeal to this Board against the Commissioner' s determination.

The Taxpayer' s contentions

4. The Taxpayer' s arguments before us were as follows:

1. For personal assessment purposes, all his rental income and interest expenses in the year of assessment 1997/98 for each of the Properties 1, 2 and 3 should be amalgamated. He contended that his total interest expenses should be deducted against his total income. In other words, 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.

2. In any event, he made every effort to rent, and indeed did rent, Property 1 as soon as physically possible. In this regard, the interest expense claimed was necessary to make Property 1 available to the tenant in order to generate rental

income. The totality of the facts shows that Property 1 did generate intangible income for the year of assessment 1997/98 since the provisional tenancy agreement was signed in mid-March 1998.

3. Again in any event, the interest deduction claimed for Property 1 was allowable as a business expense under section 42(2)(b). In this regard, the Taxpayer cited to us two dictionary definitions including that appearing in Webster' s Dictionary that ' business' has a very wide meaning importing moneymaking activity or commerce and includes ' a profit-seeking enterprise or concern' . In this regard, the Taxpayer also referred us to the fact that there are many public companies listed in Hong Kong whose business consists of property rental.

Reasons for our decision

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) or section 42(2) (see below).

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)

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 total taxable income.

8. In this regard, we reject the Taxpayer' s contention that we should take into account some notion that he received intangible income from Property 1 in the year of assessment 1997/98. The facts in this regard are clear. The term of the Property 1 lease commenced on and from 1 April 1998; no rental income was received by the Taxpayer from the tenant of Property 1 before 1 April 1998 (fact 6 refers); and in his tax return for the year of assessment 1997/98, the Taxpayer acknowledged that he did not receive any rental income from Property 1.

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 the 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).

Section 42(2)

10. As indicated above, the Taxpayer argues that, in any event, he is entitled under section 42(2) to a deduction for the disputed interest expense because his rental activities amounted to carrying on business.

11. In relevant part, section 42(2) states:

> *' There shall be deducted from the total income of an individual for any year of assessment –*
>
> *(b) the amount of the individual's loss or share of loss for that year of assessment computed in accordance with Part IV.'*

12. To be eligible under personal assessment to claim the disputed amount as a deduction from total income under section 42(2), the Taxpayer must show that his activities in relation to his rented properties could properly be described as carrying on business. The Taxpayer's arguments and our comments thereon are as follows:

- Argument The Taxpayer drew an analogy by noting that there are many public companies listed in Hong Kong whose business consists of property rental.

  Comment The analogy is not appropriate. Not only is there a ' practical difference' between the actions of an individual and that of a company ' whose sole raison d'être is ... the conduct of a trade or business' (see Lam Woo-shang v CIR (1961) 1 HKTC 123 at 149 per Hogan CJ) but, more importantly, a company that lets property is deemed to carry on business whereas an individual who lets property, as distinct from sub-lets property, is not deemed to carry on business (see definition of ' business' in section 2(1)).

- Argument Standard dictionary definitions indicate that ' business' has a very wide meaning. As the Taxpayer's rental activities were conducted for the purpose of moneymaking, or could be categorised as a profit-seeking concern, then it should be accepted that he carried on business.

Comment It is true that in many areas of taxation law the threshold for carrying on business is very low and easily satisfied. However, in the case of individuals leasing premises, even though the premises were furnished and maintained and supervised by that individual, it has been decided in the Superior Courts of Hong Kong that the threshold is relatively high and not easily satisfied. In Lam Woo-shang v CIR (1961) 1 HKTC 123 at 149-150 Hogan CJ stated:

'*We cannot perceive that the provision of furniture for the purpose of facilitating the letting of property, in itself, converts the case from one of ordinary investment to one of carrying on a business. ... From one point of view, the Taxpayer acted no differently from the manner in which any ordinary landowner would act, namely, in turning her property to account in the normal way in which landed property is turned to account, that is to say by letting it at the best rent. If the taxation net is to be cast so wide as to embrace furnished lettings on the basis that that amounts to a business then anyone who invests his money in the purchase of landed property and then proceeds to turn it into account in the ordinary course, as by letting it, furnished if necessary to facilitate the lettings, is to be held to be carrying on a business. It is no answer, in our view, to the question posed above, as to when "investment" ceases and the "business" of letting commences, to say: when the premises are furnished, even if one were to add to that: to make them more marketable; nor to say: when there is a plurality of lettings.*'

13. In rebuttal the Taxpayer sought to distinguish Lam Woo-shang's case by noting that the taxpayer only let the property (following an unsuccessful development for sale) because she could not sell it. He contrasted his case where he purchased properties specifically for letting, where he provided various services to tenants in order to more readily let the properties, and where he expended effort and undertook risk to earn rental income.

14. In our view, however, Lam Woo-shang's case was even stronger than the Taxpayer's case. There, the taxpayer was a property developer and the view could have been taken (but was not) that letting was part of, or at least tangential to, the business of property development. Moreover, the taxpayer let the relatively large number of 12 furnished flats (although we accept that there is no magic in the precise of number of lettings) and employed a part-time assistant. In the present case, the Taxpayer was not a property developer, he only let three flats, employed no assistant and had no business registration. On the facts found by us, we cannot see how it could be concluded that the Taxpayer carried on business yet under common law the taxpayer in Lam Woo-shang did not.

15. In the event, we can do no better than to paraphrase the words of Hogan CJ and conclude, on the facts found by us, that the Taxpayer acted no differently from any ordinary landlord seeking to turn his property to account in the normal way by letting it out at the best rent.

As in Lam Woo-shang the Taxpayer' s actions in the round were not in law sufficient to convert an ordinary investment to one of carrying on business.

16. Before leaving this issue, we should add that even if we were to find that the Taxpayer did carry on a property letting business in the year of assessment 1997/98, the interest payments prior to the issue of the occupation permit for Property 1 could not have been deducted. A recent case, Wharf Properties Ltd v CIR [1997] 1 HKC 184; [1997] STC 351, would bind us to conclude that interest expenses incurred on the provision of land and buildings used by a taxpayer as a capital asset in its business must be capitalised (and not immediately deducted) if incurred prior to the issue of the occupation permit. It follows that even if we accepted the Taxpayer' s main argument this would, unfortunately for him, be a case of ' winning the battle but not the war' .

17. Finally, we should add that we see the force of the Taxpayer' s arguments if taxation were based upon economic concepts rather than the force of the law. However, it is trite, but true, that taxation is not always fair. We must apply the law as enacted and as interpreted by courts whose decisions bind us.

18. For all the above reasons we dismiss this appeal.