September 20, 1928.

OPINION No. 1502.

TAXATION—INCOME TAX—DEDUCTIONS:

Under R. L. 1925, Section 1391, a taxpayer, in his income tax returns, is entitled to deduct from his gross taxable income the necessary expenses incurred in managing investments, the income of which, though returnable, is not subject to assessment of the income tax thereon.

Honorable Henry C. Hapai,
Treasurer, Territory of Hawaii.
Honolulu, T. H.

Dear Sir:

Your letter of the 8th inst., requesting a ruling as to whether a taxpayer, in his income tax return, is entitled to deduct from his gross taxable income the expenses of handling non-taxable dividends, has been referred to me by the Attorney General for consideration.

The facts as set forth in the letter to you of Mr. Henry Glass, Income Tax Assessor, dated September 4, 1928, which was enclosed with your said letter, are as follows:

Certain taxpayers have filed individual income tax returns which show the greater part of their respective incomes to be derived from dividends on the stock of corporations which are taxed under the Territorial income tax law (Chapter 103, R. L. 1925), which dividends, as hereinafter explained, are not subject to assessment for income tax; but such taxpayers have, in their returns, deducted the expenses (such as bookkeeper's salaries, etc.) of handling these investments. The question is whether such deductions are proper, or whether deductions should be allowed only for expenses incurred

in handling investments the income of which is subject to assessment of the income tax.

Under the last paragraph of Section 1391, R. L. 1925, amounts received by taxpayers as dividends upon the stocks of corporations upon which has been assessed the tax upon net profits provided for by Chapter 103, R. L. 1925, and more particularly Section 1389 in said chapter, are not assessable for income taxes. I might point out, however, that while such dividends are not *assessable,* nevertheless, under Section 1390, R. L. 1925, they must be returned by the taxpayer receiving them. I desire to call special attention to the point because it appears from the Income Tax Assessor's letter, above mentioned, that he has some doubt as to whether such dividends are returnable income.

This point was considered by the local Supreme Court in *Frear v. Wilder,* 25 Haw. 603, 607, as follows:

"We cannot concur in the statement of the attorney general that all of the items required to be returned under the provisions of section 1307" (R. L. 1915, which is sectlon 1390, R. L. 1925) "are taxable income. *Dividends on the stock of corporations are required to be returned* under the provisions of that section but under the following section" (that is section 1308, R. L. 1915, which is section 1391, R. L. 1925) "that income is exempt from taxation if the taxation of two per cent has been assessed upon the net profits of the corporation."

If such dividends are returnable, though not subject to the payment of income taxes thereon, there would seem to be some reason, aside from other considerations, for allowing the taxpayer receiving the same to deduct from his *assessable income* at least the necessary expenses of bookkeeping. The law requiring the taxpayer to keep accounts of such dividends—as he must do, in order to be able correctly to return the same—it can well be argued that the necessary expenses of keeping such accounts should be deductible from the recipient's taxable income, especially in view of the fact that the monies

out of which such dividends are paid have already been taxed under the same law and could well be omitted from the list of items required to be returned by the taxpayer receiving such dividends.

This view is strengthened by the wording of the second paragraph of Section 1391, R. L. 1925, which provides that:

"In computing incomes the necessary expenses actually incurred in carrying on *any* business, trade, profession or occupation, or in managing any property, shall be deducted * * *"

It will at once be seen that the deductible expenses are not limited only to those incurred in carrying on businesses, etc., and in managing properties, the income of which is taxable, but such expenses are expressly declared to be those incurred in carrying on *any* business, etc., or in managing *any* property. And whether we apply to this situation the doctrine of strict construction of a tax statute in favor of the taxpayer, or whether we apply the opposite doctrine of strict construction against a taxpayer claiming exemptions—if the claiming of deductions in such a case may properly be called such, as to which I have serious doubts—it seems to me that the statute is sufficiently explicit to require in any case the determination of the question in favor of the taxpayers claiming the deductions in this case.

Lest it appear that this view has been adopted without a proper consideration of the authorities, I desire to call your attention to *Black on Income Taxes,* Second Edition, Section 293, to the effect that:

"Provisions of this kind should be construed with some measure of liberality. Thus it is held that, where a statute taxes a certain class of corporations (such as insurance companies) only upon income derived from one particular source (such as mortgages), and allows all taxpayers to deduct expenses incurred 'in the production of their income,' such a company is entitled to deduct all the expenses incurred in the production, not merely of its income from mortgages, but of its income as a whole."

In the case cited in the text in support of the statement just quoted, the facts were as follows: Under the income tax statute of New South Wales, the incomes of mutual life assurance societies, with the exception of "income derivide from mortgages," were declared to be "exempt from income tax." Another section of the statute provided that "from the taxable amount * * * every taxpayer shall be entitled to deductions in respect of the annual amount of—

"(1) Losses, outgoings including interest and expenses actually incurred in New South Wales by the taxpayer in the production of his income."

The taxpayer, a mutual life assurance society, returned its income derived from loans on mortgages as the gross amount of its taxable income and deducted from said amount all expenses incurred in the production of its entire income both from loans on mortgages and from other sources. The Commissioners for Taxation disallowed the claim of deductions, though they were willing to allow a deduction of so much of the taxpayer's expenses as could be shown to have been incurred in the production of the society's "income derived from mortgages." Upon appeal, the Supreme Court of New South Wales decided in favor of the taxpayer—affirming the taxpayer's right to deduct the expenses incurred in the production of its entire income—and the case was finally appealed to the English Privy Council, which, in affirming the lower court's decision, held that:

"The principle of the decision is perfectly sound. It is obvious that the conclusion at which the Commisioners of Taxation arrived cannot be reached without introducing come limitation or some qualification which is not to be found in the words of the Act. The words 'in the production of his income'—that is, in the production of the income of the taxpayer entitled to the deduction mentioned in the Act—in their natural and ordinary meaning, apply to the income of the taxpayer as a whole. Though it would certainly have led to a variety of nice and difficult questions, it might have been more logical, it might have been more in accordance with the fitness of things, it might have made the scheme of the Act look more symmetrical, if the taxpayer claiming deduction had been confined to deductions immediately connected with or properly attributable to his taxable income. But that is not what the Act says. And it is the duty of the Court to construe the Act as they find it.

"Their Lordships will, therefore, humbly advise Her Majesty that the appeal ought to be dismissed."

"*Commissioners of Taxation v. Teece (1899)* App. Cas. 254.

In the case just cited the facts were less favorable to the taxpayer's claim than in the case presented for our determination, for, in the former, the deductions allowable to a taxpayer were stated to be "expenses actually incurred * * * *in the production of his income* "whereas in the latter, the allowable deductions are stated to be "necessary expenses actually incurred in carrying on any business, * * * or in managing any property" (R. L. 1925, Section 1391), the language being much broader than in the Teece case, *supra.* This office believes that decision to be in point and agrees with the same.

You are, therefore, advised that, if, in the opinion of the Income Tax Assessor, the deductions claimed by the taxpayers are "necessary expenses actually incurred" in carrying on the businesses, etc., or in managing the properties, which have produced the dividends referred to by him, such deductions should be allowed, notwithstanding the fact that the income so produced is not subject to the payment of the income tax thereon.

Respectfully yours,

C. NILS TAVARES,
Second Deputy Attorney General.

APPROVED:

H. R. HEWITT,
Attorney General.