Case No. D12/24

Personal Assessment – deductible interest – whether purpose of loan was to produce rental income – mortgage refinancing – sections 42(1), 68(4) and 68(7) of the Inland Revenue Ordinance – new evidence

Panel: Maurice Joseph Chan (chairman), Law Man Chung SC and Lo Sze Man.

Date of hearing: 9 May 2023.
Date of decision: 2 December 2024.

The Appellant challenged the Commissioner's determination dismissing his claim for deduction of mortgage interest expense of $67,947 under an additional personal assessment for the year 2020/21.

In September 2013, the appellant acquired a property for $6 million. To finance the purchase as a family residence, he obtained a mortgage loan of $4.2 million (1st Loan). On 31 October 2016, he obtained another mortgage loan on the property in the amount of $4,080,000 (2nd Loan). The bulk of the proceeds was used to redeem the 1st Loan, while a surplus fund of $197,647 (Additional Fund) was deposited into his personal bank account.

From 31 October 2016, the appellant continued to use the property as a family residence. Between 7 August 2019 and 22 July 2021, the property was let out by the appellant to earn rental income. Such rental income covered the assessment year of 2020/21. The property reverted to its former use from 7 August 2021.

For the year of assessment 2021/21, the appellant paid total interest of $67,947 for the 2nd Loan. He contended that the entire sum of $67,947 ought to be deductible interest payments on the basis that the purpose of the 2nd Loan was to produce chargeable rental income of the property. In particular, the Additional Fund was used to support the maintenance of the Property on a perpetual basis.

The Commissioner accepted that the portion of the 2nd Loan applied to redeem the 1st Loan was borrowed for the purpose of producing rental income, and accordingly allowed $64,655 of the interest for deduction. The balance of $3,292 (being $67,947 minus $64,655) was disallowed on the ground that the appellant's claim regarding the use of the Additional Fund for property maintenance was factually unproven.

Held:

1. The Commissioner had taken the generous view that the amount linked to repayment of the outstanding principal of the 1st Loan was borrowed for the

purpose of producing property income. Although the Board has reservation as to whether such a concession is logically sound, no issue arises out of it.

2. On the appellant's own evidence, the purpose of the 2nd Loan was merely to save interest costs. He did not borrow the Additional Fund for the production of rental income. The appeal could be dismissed on this basis alone (D50/96, IRBRD, vol 11, 547; D103/89, IRBRD, vol 6, 379; D2/91, IRBRD, vol 5, 532 considered).

3. The appellant failed to identify any documentary evidence to support his claim that the Additional Fund was exclusively applied to produce rental income. None of the bank statement entries said to relate to maintenance expenses pertain to the assessment year of 2020/21.

4. The appellant did not provide any explanation as to why the new evidence produced in closing submissions was not produced earlier and thus failed to satisfy the first requirement in Ladd v Marshall (Ladd v Marshall [1954] 1 WLR 1489; D112/00, IRBRD, vol 15, 943; D29/06, (2006-07) IRBRD, vol 21, 554 considered).

Appeal dismissed and costs order in the amount of $15,000 imposed.

Cases referred to:

D103/89, IRBRD, vol 6, 379
D2/91, IRBRD, vol 5, 532
D50/96, IRBRD, vol 11, 547
Ladd v Marshall [1954] 1 WLR 1489
D112/00, IRBRD, vol 15, 943
D29/06, (2006-07) IRBRD, vol 21, 554

Appellant in person.
Cheng Nga Man and Lee Shun Shan, for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal by the Appellant, Mr A against the Determination of the Commissioner of Inland Revenue **('Commissioner')** dated 6 Jan 2023, which, *inter alia*, dismissed Mr A's claim for deduction of the mortgage interest expense of $67,947, under an Additional Personal Assessment for the year of assessment 2020 to 2021.

2. The background facts are as follows:

(1) On XX September 2013, Mr A acquired the property **('Property')** known as Address B for $6 million. To finance such a purchase for the

family residence (whether for himself or his loved ones), he obtained a mortgage loan for $4.2 million from Bank C (**'1st Loan'**).

(2) At all material times, he maintained a Bank C personal bank account**,** Account No. XXX-XXXXXX-XXX **('Bank Account')**. As at 31 October 2016, the opening balance stood at $1,171,268.60, and the outstanding principal of the 1st Loan stood at $3,882,353. On the same day, he obtained another mortgage loan on the Property for $4,080,000 **('2nd Loan')**, and used the bulk of monies to redeem the 1st Loan. The draw down sum of $4 million odd was deposited into the Bank Account. As a result of these transactions:

(a) there was a surplus fund of $197,647 from the 2nd Loan (being $4,080,000 less $3,882,353), which the parties referred to as the **Additional Fund**;

(b) the closing balance of the Bank Account as at 31 October 2016, stood at $1,366,329.90, which is roughly equivalent to $1,368,915.60(being$1,171,268.60+$4,080,000-$3,882,353).

(3) From 31 October 2016, Mr A continued to use the Property as a family residence. This changed on 7 August 2019, when he let out the Property to earn rental income. The letting continued until 22 July 2021. Such rental income covered the entire assessment year of 1 April 2020 to 31 March 2021. From 7 August 2021, the Property reverted to its former use.

(4) For the year of assessment of 2020/21, the total interest paid for the 2nd Loan amounted to $67,947. Expenses relating to the Property were incurred between 12 May 2019 to 17 June 2021. They were said to be outlays for decoration, air conditioner, water heater, replacement of water pipes, rates and government rent, and management fees, etc.

(5) Mr A contended that the entire sum of $67,947 ought to be deductible interest payments, for the purpose of the 2nd Loan was to produce income. The Commissioner rejected such a claim in the Determination dated 6 January 2023 as factually unproven. Arising out of this, one hotly contested issue between the parties is whether these expenses were all paid from the Bank Account, or from other sources (such as by cheques drawn on other bank account(s), Alipay, Visa, Bank D Visa, and other sources, etc). Mr A appealed to this Board to have all the relevant issues resolved.

The Ordinance

3.1 ***Section 42(1) of the Inland Revenue Ordinance (Chapter 112)*** **('Ordinance')** provides that:

> '*For the purposes of this Part the total income of an individual for any year of assessment shall be the aggregate of the following amounts – ... [(a)(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 there shall be deducted from that part of the total income ... 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 4.'*

3.2 ***Section 68(4) of the Ordinance*** provides that:

> *'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

The Relevant Case Law

4.1 In Board Decision D103/89, the taxpayer purchased certain properties with loans to finance such purchases. Over time, the loans were repaid, and the properties were re-mortgaged to secure a loan and an overdraft in an overdraft account. The taxpayer claimed deductions for the interest accrued on his overdraft. But the overdraft account was used for a variety of personal and business purposes. In dismissing the taxpayer's appeal, the Board held that the taxpayer failed to demonstrate that the interest was paid on monies borrowed for the purpose of producing income, stating at page 383, that:

> *'14. What has to be established under the proviso of section 42 is the purpose for which the money was borrowed ... . But once deposits of cash went into that account and there were then withdrawals for other purposes, it is difficult to see how it could be said that the borrowings were wholly for the purpose of producing chargeable income. And when the entire borrowing was repaid, ... it is then up to the Taxpayer to demonstrate that the withdrawal nevertheless were for the purpose of producing chargeable income under section 42(1).'*

4.2 In Board Decision D2/91, the taxpayer exchanged his property, A, with his mother's property, B. A was subject to a mortgage. To effect the exchange, it was necessary for him to discharge the mortgage on A. He obtained such funds by mortgaging B, which was used to produce rental income. The Board allowed the taxpayer's claim on the interest deductions, to the extent of what was necessary to redeem the mortgage on A. On the question of apportionment, the Board found that about $300,000 of the total of $472,000 borrowed was money needed to acquire B, whereas the surplus of $172,000 was for other purposes which the Board was not concerned with. The Board reasoned that if the taxpayer had not paid off the mortgage on A, he could not have acquired B at all. So in these circumstances, the interest which the taxpayer had been required to pay on the moneys borrowed must be partially allowed to be deducted from his rental income. But the full interest amount on the loan of $472,000 could not be so allowed, because only $300,000 was used to acquire B. As the Taxpayer could not work out the exact sum when the case was heard, the Board remitted the matter back to the Commissioner so that the exact amount could be ascertained.

4.3 It should be observed that in that case, the underlying basis for the apportionment between the interest on $300,000 attributable to the acquisition of the rental property B, and interest on $172,000 for other purposes, was that B was used as a letting for producing rental income. What ought to be also apparent, is that:

(1) Had property B not been used as a letting to produce rental income but as a family residence, no issue of apportionment of the type contemplated by the Board would arise.

(2) The kind of apportionment the Board was dealing with was one between interest attributable to the redemption fund, and interest attributable to the surplus fund. The Board was not there dealing with the kind of apportionment contemplated in Board Decision D103/89 between the interest attributable to income producing purposes and non income purposes, in a bank account for multiple purposes.

4.4 In Board Decision D50/96, the taxpayers, being husband and wife, owned 3 properties. To provide sufficient living area for their family, they purchased property C by mortgaging properties B and C. Immediately prior to the purchase of C, B was first used as a family residence, and then later, rented out. But property A was rented out at all times. They sought to deduct mortgage interest applicable to B. The sole issue before the Board was whether the money on which the interest was paid had been borrowed for the purpose of producing income. After consulting the Concise Oxford Dictionary, the Board interpreted ‘purpose’ as generally relating to a person's ‘design’ or ‘intention’. So given such a meaning, the taxpayers' ‘acknowledged purpose’ in borrowing the funds was to finance the purchase of C as a family residence to improve living conditions.

4.5 It was also held that although one effect or consequence was to create a rental stream when B's use changed from self residence to a letting, it was not open to the couple to conclude that their purpose in borrowing money to purchase C had been to produce income.

4.6 Before concluding, the Board observed that the answer would be different if they had lived in B and leased C, and said:

> *‘tax is imposed upon what they did; it is not imposed upon what they could have done.’*

The Appellant's Arguments

5.1 In his appeal against the Additional Personal Assessment issued on 31 May 2022, Mr A argued that the entire amount of interest paid for the 2nd Loan during the assessment year of 2020/21, being $67,947, was for producing chargeable rental income of the Property, and therefore, should be deductible. He contended in effect that the 2nd Loan of $4,080,000 was used for 2 purposes:

(1) $3,882,353 thereof was to repay the outstanding principal of the 1st Loan; and

(2) $197,647 thereof, ie, the Additional Fund, was used to support the maintenance of the Property on a ‘perpetual basis’ or ‘until my ownership ends including … end of my life’.

5.2 To make good his claim that he needed to support the maintenance of the Property almost in perpetuity, Mr A claimed that he had to pay a myriad of **Expenses** such as management fees, rates and government rent, maintenance and replacement of facilities, renovation cost, transaction costs such as stamp duties and estate agency fees, miscellaneous costs such as home insurance, and Government lease extensions after 2047, etc.

5.3 He also argued that the entire Additional Fund of $197,647 was ‘being expected to be even[ly] used in 30 years’. Therefore, for each of those 30 years, the amount of the Additional Fund should be deemed to be $6,588 (being $197,647 x 1/30). And considering that for the assessment year of 2020/21, his claimed Expenses totalled $33,062, the annualized Additional Fund of $6,588 was insufficient to cover his expenditure for that period. Therefore, according to this reasoning, the entire interest amount of $67,947 must be deductible.

Analysis

6.1 The Board has very carefully considered Mr A's arguments. Despite our sympathy with Mr A's position, the Board has come to an inevitable conclusion that this appeal must fail.

6.2 What should first be appreciated at the outset, as a preliminary matter, is that the Commissioner had taken the generous view that the amount limited to repayment of the outstanding principal of the 1st Loan was deemed to be borrowed for the purpose of producing property income. So on this basis, $64,655 of the interest payable for the 2nd Loan was allowed for deduction under the proviso, $64,655 being $67,947 x 3,882,253 x 1/$4,080,000. Its rationale is that under the 2nd Loan, $3,882,253 out of $4,080,000 had been applied to redeem the 1st Loan. Ms Cheng Nga Man **(‘Ms Cheng’)**, for the Commissioner, submitted that since the character of the refinancing takes on the same character as the original borrowing, $3,882,353 out of the 2nd Loan could be deemed to be borrowed for the purpose of producing rental income.

6.3 Although the Board has reservation as to whether such a concession is logically sound, no issue arises out of it. What is in dispute is that the parties are, in effect, merely contesting, as a matter of principle, over whether $3,292 (being $67,947 - $64,655) is deductible interest. However, on this very narrow issue, the Board has concluded that there are no merits in Mr A's appeal.

6.4 The Board's reasons are as follows:

(1) At the time of Mr A's borrowing of the 2nd Loan, the Property was used as a residence, and had never been rented out.

(2) Mr A himself admitted that the purpose of switching from the 1st Loan to the 2nd Loan, was to take advantage of the favourable HIBOR based interest rate of the latter, over the unfavourable P rated interest rate of the former. According to Mr A, his exit strategy was said to be a result of a consultation with Bank C. In other words, the purpose of the Mr A's 2nd Loan was merely to save interest costs. According to his own case, his 'acknowledged purpose' had never been an intention or design to borrow the Additional Fund of $197,647 on 31 Oct 2016 for the production of rental income. Thus Mr A's appeal could be dismissed on this basis alone, in the same way as Board Decision D50/96 was dismissed, the acknowledged purpose there being to improve living conditions.

(3) Moreover, after the 2nd Loan, Mr A continued to use the Property as a residence. It was not until 7 August 2019 (ie almost some 2 years and 3 quarters later) that he started to let the Property out to generate rental income. Thus, this incontrovertible fact does not support Mr A's arguments on the purpose of his 2nd Loan.

(4) Further, the letting only continued until 22 July 2021, over a period of just under 2 years, and not in perpetuity, or for his life time, or for 30 years as Mr A alleged. Thereafter, the Property resumed to its former use as a family residence; so it turns out that the historical facts, after all, do not fall in line with his 30 year or life expectations.

(5) As a matter of fact, the entirely of the 2nd Loan of $4,080,000 was deposited to his Bank Account on 31 October 2016, and therefore mixed with his own initial balance of $1,171,268.60. After discharging the 1st Loan of $3,882,353, there was a closing balance of $1,366,329.90. But Mr A also says that the purpose of the Additional Fund of $197,647, could be exclusively deemed to produce rental income. However, at the hearing, Mr A had not been able to identify any entries in the bank statements of his Bank Account as expenses relating to the production of any rental income. On examining the documentary evidence in the hearing bundles, we were still unable to identify any documentary evidence to support this claim.

(6) Mr A has failed to discharge the burden placed upon him to prove his claim. He fails to demonstrate that the sole purpose of his borrowings was to produce rental income.

(7) It should also be appreciated that because the Additional Fund of $197,647 was mixed with the monies in the Bank Account on 31 Oct 2016, and then ended up as a portion of the closing balance of $1,368,915.60, the other portion must be $1,171,268.60 (ie, $1,368,915.60 less $197,647); the Additional Amount amounts in effect, to about 14.44% of the closing balance. But in such circumstances, it will be somewhat artificial to say that any item of withdrawal necessary relates to a withdrawal of the $197,647 portion, and not the other portion of $1,171,268.60;

(8) In Mr A's Closing Submissions, he had highlighted certain entries on his bank statements as expenses he contends to be relating to the production of rental income. However, out of the 8 pages of bank statements he referred to, none of the transaction entries therein pertain to the assessment year of 2020/21; they amount to a total of $58,372 consisting of:

(a) pre-letting transactions of May 2019 and June 2019, when the Property was still used as a family residence;

(b) what appears to be letting related transactions on:

(i) 6 August 2019 for $1,200 paid to Company E, but in settlement of an invoice of Company F dated 2 Aug 2019 for window safety works, with an instruction to pay $2,000 (being $1,200 + $800) to a bank account of Person G and Person H;

(ii) 22 Jun 2019 for $9,000 as deposit for maintenance work water pipes; and

(c) post-letting transactions of August 2021;

Although the letting spanned from Aug 2019 to Jul 2021, Mr A was still not able to produce any evidence of Apr 2020 to Mar 2021 transactions.

(9) Regarding the Closing Submissions, it was also pointed out by Ms Cheng that the evidential documents on pages 7, 10, 13, 16, 20, 21, 22 and 24, by way of receipts, e-confirmations, and stamp certificates, are all new materials never previously placed before the Board; citing Ladd v Marshall [1954] 1 WLR 1489 and Board Decisions (D112/00 and

D29/06). The new evidence was opposed on the ground that there ought to be finality, and the Board's power under Section 68(7) of the Ordinance ought to be judiciously exercised and not arbitrarily. There is no explanation from Mr A as to why such evidence was not produced earlier and thus he failed to satisfy the first requirement in Ladd v Marshall.

6.5 Mr A had also complained repeatedly of Ms Cheng and Ms Poon Chur Yan of the Inland Revenue Department intentionally not responding to his enquiries in a timely fashion or at all. Ms Cheng has denied such criticisms as unjustified. But the Board cannot be a venue to resolve these issues which are irrelevant to this appeal, and therefore shall refrain from comment.

Conclusion

7. For all the reasons canvassed above, Mr A's appeal be dismissed with costs in the sum of $15,000. This Board remains thankful to both sides for the clarity of their opening and closing submissions.