

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D103/89

Personal assessment – deduction of overdraft interest – section 42(1) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Jao Yu Ching and Kenneth Ku Shu Kay.

Date of hearing: 23 January 1990.

Date of decision: 8 March 1990.

The taxpayer purchase certain properties and borrowed money from banks for this purpose. In the course of time the fixed property loans were repaid and the properties re-mortgaged to secure an overdraft account. The taxpayer operated the overdraft account and paid substantial sums into the account to reduce its amount and paid out sums which increased the amount of the overdraft. The taxpayer claimed as a deduction from his taxable income for personal assessment purposes all of the interest accrued on his overdraft account. This was not allowed by the assessor.

Held:

Under section 42(1) of the Inland Revenue Ordinance, the taxpayer must demonstrate that the interest was paid on monies borrowed for the purpose of producing chargeable income. The taxpayer had failed to satisfy this requirement. Cash deposits were made into the overdraft account and withdrawals made from the overdraft account for purposes other than the financing of the properties in question.

Appeal dismissed.

Lee Yun Hung for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

Introduction

1. Between April 1984 and mid-1985, the Taxpayer was a partner of a professional firm. He became the sole proprietor of the firm from mid-1985 onwards. At all

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material times the Taxpayer elected to be personally assessed and accordingly came under the provisions of part VII of the Inland Revenue Ordinance.

2. The question for the Board to consider is whether the entire amount of overdraft interest incurred by the Taxpayer in the years of assessment 1984/85 and 1985/86 is allowable as a deduction under the proviso of section 42(1) of the Ordinance.

Facts

3. The Taxpayer was the owner of the following properties:

- (i) Property A1;
- (ii) Property A2;
- (iii) Property B.

4. Property A1 and Property A2 (collectively referred to as Property A) were acquired in September 1980 at a consideration of \$725,000. The purchase was financed by a bank loan of \$580,000 from X Bank ('the original loan'). The loan was to be repaid by 120 equal monthly instalments of \$8,489.8 each commencing from October 1980.

Property B was acquired in 1981. It was financed by a mortgage loan from Y Bank.

5. In respect of the original loan, monthly repayments were made regularly until July 1983 when the balance of the original loan (\$534,850.83) was replaced by a new loan ('the second loan') of \$250,000 and an overdraft of \$250,000. The overdraft was fully drawn down at the beginning to pay off the original loan, the balance of \$34,850.83 coming from other resources of the Taxpayer.

6. About a year later (in July 1984) the second loan was fully paid off and loan interest of \$10,422 was incurred by the Taxpayer from 1 April 1984 to 10 July 1984. A cheque payment of \$236,000 into the overdraft account on 10 July 1984 changed the overdraft account for the first time from a debit position to a credit position: from an overdraft of \$229,738.48 as at 10 July 1984 to a credit balance of \$6,261.52. Interest amounting to \$9,075 was paid to X Bank in respect of the overdraft account up to 10 July 1984.

7. The overdraft account turned into a debit balance again with effect from 27 July 1984, and the following amounts of interest were paid to X Bank in respect of the overdraft account:

Overdraft Interest

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(i)	27 July 1984 – 31 March 1985	<u>\$29,733</u>
(ii)	1 April 1985 – 30 November 1985	\$23,384
(iii)	1 December 1985 – 31 March 1986	<u>\$6,419</u>
		<u>\$29,803</u>

8. Letting of Property A and Property B ceased in late 1985. Accordingly no deduction of interest could be claimed when rental income ceased: see section 42(1)(a) of the Ordinance.

Taxpayer's Claim

9. The Taxpayer claimed that the following amounts of interest incurred should be allowed as deduction in the assessments issued to him under part VII of the Ordinance:

(a)	<u>Year of assessment 1984/85</u>	
(i)	Interest paid to Y Bank in respect of Property B	\$22,127
(ii)	Interest paid to X Bank in respect of Property A	
	- on mortgage loan (for period 1 April 1984 to 10 July 1984)	\$10,422
	- on overdraft account (for period 1 April 1984 to 31 March 1985)	<u>\$38,808</u>
		<u>\$71,357</u>
(b)	<u>Year of assessment 1985/86</u>	
	Interest paid to X Bank in respect of Property A on overdraft account (for period 1 April 1985 to 31 March 1986).	<u>\$29,803</u>

10. In the Commissioner's determination, only the following amounts of interest incurred by the Taxpayer were allowed by way of deduction:

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(a)	<u>Year of assessment 1984/85</u>	
(i)	Interest paid to Y Bank in respect of Property B	\$22,127
(ii)	Interest paid to X Bank in respect of Property A	
	- on mortgage loan (for period 1 April 1984 to 10 July 1984)	\$10,422
	- on overdraft account (for period 1 April 1984 to 10 July 1984)	<u>\$9,075</u>
		<u>\$41,624</u>

(b) Year of assessment 1985/86

Entire amount of overdraft interest claimed by the Taxpayer was disallowed.

11. In dispute therefor is the following:

(a) Year of assessment 1984/85

Interest on overdraft account from 11 July 1984 to 31 March 1985

(b) Year of assessment 1985/86

Interest on the overdraft account for the whole year 1 April 1985 to 31 March 1986.

Taxpayer's Case

12. The Taxpayer accepts of course the fact that mortgage loan was discharged on 10 July 1984 by payment. It is however his case that the payment of \$236,000 into the overdraft account on 10 July 1984 did not have the effect of discharging the entire borrowings made in respect of the purchase of Property A. He says that, within a short time of 10 July 1984, the overdraft account was in debit again and remained in debit for the rest of the period terminating on 31 March 1986. His case is that his re-structuring of the loans in 1983 (see paragraph 5 above) was to accelerate repayment and thus save interest. He says that the payments into the overdraft account were temporary and that those payments were from the following sources:

- (a) liquid cash in hand not required for immediate payment purposes;

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- (b) working capital of the firm (owned by him) not required for immediate purposes and
- (c) funds earmarked for other purposes temporarily available for short periods of time.

Very soon after payment in, other sums were withdrawn. The effect of all this, says the Taxpayer, is that the borrowings by way of overdraft for the purchase of Property A remained in place, and interest incurred on such borrowings should have been allowed as a deduction against chargeable income.

13. What is quite clear is that by the time under consideration (July 1984) the overdraft account was used by the Taxpayer for a variety of personal and business purposes. Indeed, in examining the bank statements for that account, it can be seen that even prior to 10 July 1984 there were substantial deposits into and withdrawals from that account: there was, for example, a deposit on 26 May 1984 whereby the overdraft was reduced to \$78,122.76, and a further deposit on 31 May 1984 of \$26,000 reduced the overdraft still further to \$52,122.76. Then in June 1984 there were substantial withdrawals and deposits, and it is the Taxpayer's case that the small credit in that account between 11 July and 27 July 1984 did not affect the overall pattern. If the Commissioner should allow interest to be deducted up to 10 July 1984, why should he disallow the deduction of interest thereafter?

Conclusion

14. What has to be established under the proviso of section 42 is the purpose for which the money was borrowed. The original overdraft of \$250,000 was unquestionably for the purpose of producing chargeable income under section 42(1) since that sum went to discharge the original loan. 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, however temporarily, and the account was operated for a variety of purposes, it is then up to the Taxpayer to demonstrate that the withdrawals nevertheless were for the purpose of producing chargeable income under section 42(1). This he has totally failed to do. Indeed, he has shown the opposite.

15. It may well be the case that even prior to 10 July 1984 part of the interest charged on the overdraft account should have been disallowed. But apportionment would have been an almost impossible exercise and the Commissioner sensibly took the practical course of allowing all the interest until the overdraft was repaid.

16. In our view this appeal fails and must be dismissed.