Case No. D18/02

Salaries tax – whether certain amount of a loan falls within the 'home loan' definition of section 26E of the Inland Revenue Ordinance ('IRO') – unreasonable to treat the full amount of a subsequent loan as a home loan given the amount of that subsequent loan was in excess of the purchase price of the property and the outstanding principal of the original loan – unreasonable to treat a subsequent loan as having replaced the original loan at the original rate of interest – taxation is assessed on an annual basis – no justification in law for granting the home loan interest deduction by adopting historical facts – section 26E of the IRO.

Panel: Andrew Halkyard (chairman), Edward Cheung Wing Yui and Ho Kai Cheong.

Date of hearing: 8 May 2002.
Date of decision: 7 June 2002.

This was an appeal against the salaries tax assessment raised on the appellant for the year of assessment 1998/99.

The appellant and his wife ('the Couple') had purchased a property ('the Property') in 1989 as their residence. They financed the purchase mainly by way of a loan from a finance company ('Loan A'). On four occasions between March 1991 and March 1996, the Couple used the Property as security for further loans from the same finance company. The purpose of obtaining such additional loans was not disclosed to the Board.

The Couple refinanced their residence twice in October 1996 and August 1997 respectively. On the second occasion, the Couple obtained a new loan of $4,000,000 ('Loan B') from a bank and repaid the refinanced Loan A. The Inland Revenue Department allowed a deduction of home loan interest on the basis that Loan B replaced Loan A and thus could be treated as a 'home loan interest' under section 26E of the IRO.

The only issue in this appeal was the computation of the 'home loan interest' actually paid by the appellant in the year of assessment 1998/99. Was the formula adopted by the Commissioner fair and reasonable in all the circumstances?

The facts appear sufficiently in the following judgment.

Held:

1. The Board found that the formula adopted by the Commissioner in the computation of the 'home loan interest' was fair and reasonable in all the circumstances.

2. It was not reasonable to treat the full amount of Loan B as a home loan and thus allow all the interest payable on that loan as home loan interest, given that the amount of Loan B was several times in excess of the then outstanding principal referable to Loan A and more than three times in excess of the purchase price of the residence.

3. It was not reasonable to treat Loan B, which was obtained in 1997, as having replaced the original amount of Loan A at the original rate of interest.

4. Taxation was assessed on an annual basis, having regard to the facts occurring in that year. There was no justification in law for granting the home loan interest deduction by adopting historical facts which were far removed from those actually existing in the year of assessment 1998/99.

Appeal dismissed.

Tsui Nin Mei for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against a salaries tax assessment raised on the Appellant for the year of assessment 1998/99. The Appellant claims that he should be entitled to a deduction for home loan interest amounting to $50,000.

The facts

2. The facts, which are not in dispute and which we so find, are set out in the Commissioner's determination dated 11 January 2002.

3. In essence, the Appellant together with his wife ('the Couple') as joint tenants purchased their residence on 28 December 1989 for $1,387,900. They financed the purchase mainly by way of a loan from Finance Company A ('Loan A') in the amount of $1,150,000. On four occasions between March 1991 and March 1996, the Couple used the residence as security for further loans from Finance Company A. The Appellant did not tell us what these additional loans were used for.

4. First in October 1996 and later in August 1997, the Couple refinanced their residence. On the second occasion, the Couple obtained a new loan of $4,000,000 from Bank B ('Loan B') and repaid the refinanced Loan A. On that date, the amount of unpaid principal referable to the initial Loan A was $759,324.25. In the year of assessment 1998/99, the Couple paid interest on Loan B of $361,572.41. The Commissioner allowed a home loan interest deduction to the Appellant of $33,102 based on the formula:

$$\text{50\% of total interest paid during the year} \times \frac{\text{Unpaid principal referable to Loan A}}{\text{Amount of Loan B}}$$

5. In his notice of appeal to this Board, the Appellant stated:

> ' [I agree with the Commissioner that] only [Loan A] can be accepted as a home loan. However, I totally disagree with the Commutations [*sic*] ... in which the Assessor has taken [the additional loans from Finance Company A] into the calculations, as these figures are all irrelevant.
>
> Since [Loan A] is accepted as a home loan, the Assessor should therefore take the actual interest rate and the amount being paid during the first year of my [Loan A] period as the calculation basis for commutation [*sic*], and not those figures after it. [The Appellant then claimed that, based on the initial amount of principal due on Loan A ($1,150,000) and the interest rate prevailing in November 1990, the Couple paid more than $100,000 on their home loan in the year of assessment 1998/99 and he thus should be granted a deduction for the year of assessment 1998/99 for one-half of the maximum amount, namely $50,000.]'

Argument and analysis

6. In the hearing before us, the Appellant argued that the Commissioner's determination was not to his advantage, that he was only eligible for a deduction for five years, and that Loan B was a home loan for which his total interest payment should qualify (up to statutory limit for a joint tenant) for the purposes of a home loan interest deduction under section 26E of the IRO.

7. Since the Commissioner has accepted that, to the extent illustrated by the formula set out above, Loan B replaced the initial Loan A and could thus be treated as a home loan under section 26E, the sole issue for our decision is one of computation of the 'home loan interest' actually paid by the Appellant in the year of assessment 1998/99. Is the formula adopted by the Commissioner fair and reasonable in all the circumstances? We think that it was. There are no facts before us that lead us to question this conclusion. Conversely, it is *not* reasonable, as the Appellant urges us, to treat the full amount of Loan B as a home loan and thus allow all the interest

payable on that loan as home loan interest, given that the amount of Loan B was several times in excess of the then outstanding principal referable to Loan A and more than three times in excess of the purchase price of the residence. It is also *not* reasonable, as the Appellant contends in his notice of appeal, to treat Loan B (obtained in 1997) as having replaced the original amount of Loan A at the original rate of interest (by reference to facts existing in 1989 and 1990). Unless the IRO states otherwise – and for the purposes of this appeal it does not – taxation is assessed on an annual basis, having regard to the facts occurring in that year. There is no justification in law for granting the home loan interest deduction by adopting historical facts which are far removed from those actually existing in the year of assessment 1998/99.

8. Before concluding, we note that apparently the Appellant is in the very unfortunate position of having purchased a property in which he had negative equity. This has been compounded by the fact that the Appellant is currently unemployed. We truly sympathise with the Appellant's plight. However, this cannot alter our conclusion that the Commissioner's determination was entirely in accordance with the law. The appeal is hereby dismissed.