

Case No. D23/10

Property tax – deduction of interest – sections 42(1) and 68(4) of Inland Revenue Ordinance ('IRO').

Panel: Chow Wai Shun (chairman), Ng Man Sang Alan and Wong Wang Tai Fergus.

Date of hearing: 18 May 2010.

Date of decision: 14 September 2010.

The Appellants owned certain properties ('the Properties') and a carparking space ('the Subject CPS') which were used as security to obtain, inter alia, Loan B in 2000 and Loan C in 2005. Part of Loan C was used to discharge the outstanding indebtedness regarding Loan B. During the year of assessment 2006/07, the Subject CPS was let out for rental income. The issue was whether interest incurred for Loan C should be deducted. The Appellants argued, inter alia, that since they needed funds for their children's education costs, they had to obtain Loan C to 'purchase' or continue to own the Properties and the Subject CPS; otherwise they would have to sell them and would not have any rental income thereafter.

Held:

1. The Appellants could have maintained the then *status quo*, continued to own the Subject CPS and rent it out for a stream of rental income. They could have continued to deduct their interest expenses under Loan B attributable to the Subject CPS until it would have been fully paid up. However, all these were made not possible because of the changed circumstances of the Appellants in which they required funds for the education costs of their children and they might not have any other sources of funding other than the Properties and the Subject CPS. The Appellants chose to re-mortgage the Properties and the Subject CPS so that sufficient fund (with reference to their estimate) could be obtained without disposing of the Properties and the Subject CPS. At best to the Appellants, the Board could only conclude that there existed dual purposes for borrowing Loan C: (a) to provide for the education costs of the Appellants' children; and (b) to maintain the ownership in, inter alia, the Subject CPS, so that the Subject CPS can continue to be rented out in return for income which is chargeable to property tax.
2. In the absence of any contrary evidence, deduction of repayments to Loan C

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should be applied proportionately to that part of the loan applicable to maintaining the ownership of the Subject CPS and that part of the loan applicable to other purposes. (D103/89, IRBRD, vol 6, 379, 383; D50/96, IBRD, vol 11, 547, 552; and D2/91, IRBRD, vol 5, 532 followed) Accordingly the interest paid during the year of assessment 2006/07 should be apportioned in the same ratio throughout the same period.

Appeal dismissed.

Cases referred to:

D103/89, IRBRD, vol 6, 379, 383
D50/96, IBRD, vol 11, 547, 552
D2/91, IRBRD, vol 5, 532

First taxpayer in person and for and on behalf of the second taxpayer.
Chan Wai Lin and Chan Man On for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 3 November 2009 ('the Determination') whereby Personal Assessment for the year of assessment 2006/07 under charge number X-XXXXXXXX-XX-X dated 14 March 2008, showing net chargeable income of \$734,640 with tax payable thereon of \$114,081 (the share of the first Appellant being \$106,652) was confirmed.

2. The first Appellant, Mr X, appeared in person and for and on behalf of the second Appellant. He raised no dispute to the facts upon which the Determination was arrived at and gave no further oral evidence. On such basis, and having considered all documentary evidence sent to the Board before the hearing, we find the following facts as facts relevant to this appeal:

- (1) The Appellants are husband and wife. At the relevant times, they were joint owners of the following properties in Court A:
 - (a) Flat B and carparking space C on basement ('the Properties'); and
 - (b) Carparking space D on basement ('the Subject CPS').
- (2) The Appellants purchased the Properties and the Subject CPS at a total price of \$4,215,000 in December 1991. On divers dates, the Appellants, with the Properties and the Subject CPS as security, obtained the

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following mortgage loans:

Date of mortgage	18-12-1991	17-4-2000	8-6-2005
Name of bank / financial institution	Institution E	Bank F	Bank G
Loan amount	\$2,900,000	\$1,600,000	\$4,800,000
Date of redemption	17-4-2000	8-6-2005	-
Balance redeemed	\$1,778,454	\$438,076	-
Referred to as	'Loan A'	'Loan B'	'Loan C'

- (3) During the year of assessment 2006/07, the Subject CPS was let out for rental income. The net assessable value of the Subject CPS for the year was \$18,960.
- (4) In her tax return for the year of assessment 2006/07, the second Appellant elected Personal Assessment and claimed deduction for her share of mortgage interest expenses in respect of the Subject CPS amounting to \$8,840.
- (5) In reply to the assessor's enquiries concerning the claimed mortgage interest in respect of the Subject CPS, the Appellants provided the following particulars:

(a)	Name of lending institution for the re-mortgaged loan	Bank G
(b)	Amount of the re-mortgaged loan	\$350,000
(c)	Interest paid for the re-mortgaged loan in the year	\$17,680 (\$8,840 x 2)
(d)	Period covered by the interest in item (c) above	1-4-2006 to 31-3-2007
(e)	Date of redemption of the previous mortgaged loan	8-6-2005
(f)	Balance of the previous mortgaged loan redeemed	\$33,500

- (6) On 14 March 2008, the assessor raised on the Appellants the following Personal Assessment for the year of assessment 2006/07:

	Total amount \$	Share of the second Appellant \$	Share of the first Appellant \$
Income from Properties [Fact (3)]	18,960	9,480	9,480
Employment	133,140	58,140	75,000
Business – Sole proprietorship	81,030	0	81,030
Business – Partnership	<u>783,902</u>	<u>0</u>	<u>783,902</u>

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Total income	1,017,032	67,620	949,412
<u>Less: Deductions</u>			
Interest payable on properties let	(1,692)	(846)	(846)
Charitable donations	<u>(700)</u>	<u>(700)</u>	<u>0</u>
Reduced total income	1,014,640	66,074	948,566
<u>Less: Allowances</u>			
Married person's allowance	200,000		
Child allowance	<u>80,000</u>		
Net chargeable Income	734,640		
	=====		
Tax Payable thereon	114,081	7,429	106,652
	=====	=====	=====

Assessor's Note:

The allowable amount of mortgage interest (the share of the second Appellant) is calculated as follows:

$$\$8,840 \times 33,500 / 350,000 = \$846$$

Notes:

- (1) The total tax payable of \$114,081 was arrived at after tax rebate of \$15,000 had been deducted.
- (2) The second Appellant's share of tax payable
= \$114,081 x \$66,074 (the second Appellant's share of reduced total income) / \$1,014,640 (reduced total income)
= \$7,429
- (7) The Appellants objected to the Personal Assessment.
- (8) In reply to the assessor's enquiries, the Appellants provided the following documents:
 - (a) A letter dated 5 May 2005 issued by Bank G to the Appellants showing the approval of Loan C.
 - (b) An annual statement of loan account dated 2 April 2007 issued by Bank G to the Appellants, which showed that the interest paid in respect of Loan C during the period from 1 April 2006 to 31 March 2007 was \$242,526.13.

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- (9) At the request of the assessor, Bank F confirmed that the outstanding principal of Loan B at the redemption date was \$438,076.13.
 - (10) The objection was unfavourably determined and the Appellants lodged an appeal to this Board.
3. During objection, the Appellants asserted, inter alia, the following:
 - (1) The total value of the Properties and the Subject CPS was about \$6,857,000.
 - (2) The amount of Loan C was equivalent to 70% of the total value of the Properties and the Subject CPS.
 - (3) The value of the Subject CPS was \$500,000, which was equivalent to 7.29% of the total value of the Properties and the Subject CPS.
 - (4) The mortgage interest paid for the Subject CPS in the year of assessment 2006/07 was 7.29% x \$242,526.13 (see Fact 2(8) above) and that is \$17,680.
4. The Appellant stated in his notice and statement of grounds of appeal the following reason and grounds which are reproduced verbatim below:
 - ‘ 1. The Commissioner erred in concluding that to keep the ownership of [the Properties], [the Appellants] only needed to borrow \$438,076.00 [or \$33,500.00 for the Subject CPS as per [Fact 2(5)(f)]] instead of \$4,800,000 or \$350,000.00 for the Subject CPS as per [Fact 2(5)(b)]]]. The Commissioner wrongly applied an objective test to arrive at the “need” of [the Appellants].
 2. The Commissioner failed to correctly interpret the proviso of Section 42 of the Inland Revenue Ordinance which stipulates that “... Provided that there shall be deducted from that part of the total income arising from paragraph (a) 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 IV” which led to the wrong determination herein.’
5. The Appellants sent in a hearing bundle on 30 April 2010. Item 1 of the bundle referred to an amended notice of appeal. Ground 1 was amended slightly:
 - ‘ 1. The Commissioner erred in concluding that to keep the ownership of [the Properties], [the Appellants] only needed to borrow \$438,076.00 [or \$33,500.00 for the Subject CPS as per [Fact 2(5)(f)]] instead of

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\$4,800,000 [or \$350,000.00 for the Subject CPS as per [Fact 2(5)(b)]].
The Commissioner applied the test to arrive at the “need” of [the Appellants] wrongly.

...’

At the hearing, Ms Chan, representing the Respondent, confirmed not to raise any issue about the amended notice.

6. At the hearing, the Appellants confirmed that they had decided to drop the second ground.

7. The issue for us to decide is, therefore, whether the Appellants were entitled to deduct the *entire* amount of mortgage interest expenses claimed by them under the Personal Assessment for the year of assessment 2006/07, that is, the mortgage interest paid for the Subject CPS in the year of assessment amounting to \$17,680.

8. The Appellants had prepared a written skeleton submission. Mr X summarized the agreed facts and drew our attention specifically to the following.

9. In or about September 2003, their family discussed the plan of sending their children, aged 16 years and 14 years respectively to the United Kingdom to further their studies after they had finished their Form 5 secondary education in Hong Kong. According to their studies, it was estimated that the annual costs and expenses for each child, including school fees, boarding fees, airfares, local guardian and daily expenses, would be over \$400,000 and that in order to finish a basic undergraduate course it would take 5 years for each child – 2 years of matriculation and 3 years at university. It meant to them that a total of about \$4,000,000 would be required for both of their children as education costs. Mr X submitted that as the costs were huge which would impose a heavy financial burden on their family, there were two options for them: ‘(i) to sell or dispose of the Properties and the Subject CPS to raise the necessary funds; or (ii) to re-mortgage them for the necessary funding.’ It was finally decided that the latter option was taken and hence the loan from Bank G in the amount of \$4,800,000 to repay firstly the then outstanding loan with Bank F and then use the balance for meeting the education costs. The Appellants enclosed the school admission letters of their two children in the hearing bundle. The whole of the Appellant’s submissions centred around this change of circumstances. We shall consider their submissions later in our decision below.

Our decision

10. The relevant provisions of the Inland Revenue Ordinance are set out below:

(a) Section 42(1) provides:

‘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) (i) ...

(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 arising from paragraph (a) 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 IV.'

(b) Section 68(4) provides:

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

11. In support of the Respondent's submissions, Ms Chan cited three previous decisions of this Board.

12. In D103/89, IRBRD, vol 6, 379, 383, this Board held that under section 42(1) of the IRO, the taxpayer must demonstrate that the withdrawals, and hence the interest paid on monies borrowed, were for the purpose of producing chargeable income.

13. In D50/96, IRBRD, vol 11, 547, 552, this Board stated:

'The proviso to section 42(1) allows the deduction under personal assessment on money borrowed for the purpose of producing income chargeable to property tax. To succeed in their claim, the Taxpayers need to establish:

(1) *that interest was payable;*

(2) *that the interest was payable on money borrowed; and*

(3) *that the money was borrowed for the purpose of producing chargeable property income.'*

In relation to the third condition, the Board, in dismissing the appeal, stated at page 553:

'Given, therefore, that "purpose" generally relates to a person's design or intention, it is clear in this case that the Taxpayer's acknowledged purpose in

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borrowing the funds from the Mortgagee was to finance the purchase of Property C as a family residence... At best we could only conclude that one effect or consequence of the Taxpayers purchasing Property C was to create a rental stream when the use of Property B was changed from self-residence to letting. It is not open to us to go further to conclude that the purpose of the Taxpayers in borrowing from the Mortgagee was to produce chargeable rental income.'

This Board also stated at the end of its decisions:

'tax is imposed upon what [the Taxpayers] did; it is not imposed upon what they could have done.'

14. In D2/91, IRBRD, vol 5, 532, the taxpayer exchanged his mortgaged property with a property of his mother. In order to effect the exchange, it had been necessary for the taxpayer to repay the mortgage, and to achieve this, he mortgaged the property which he was acquiring. The loan obtained was greater than what was necessary to redeem the mortgage on his former property. The Board allowed the taxpayer's claim to the extent of what was necessary to redeem the earlier mortgage. Regarding the repayment of loan and the apportionment of interest expenses, the Board provided, at page 535, the following guideline:

'... the bank loan which the Taxpayer obtained on the property was repayable by instalments and accordingly the interest is on a reducing balance. As no contrary evidence was given it is reasonable that deduction of repayments should be applied proportionately to that part of the loan applicable to the property and that part of the loan applicable to other purposes. Accordingly the interest paid during the year of assessment in question would be apportioned in the same ratio throughout the period in question.'

15. In their written skeleton submissions, the Appellants referred to both D103/89 and D50/96 which were also cited in the Determination. They made no reference to D2/91. They submitted that the two cases were different and distinguishable from the present case. In his oral submission, the husband said that they were not disputing the ratio of the cases but opined that they could be distinguished. However, he did not go further to point out specifically any such distinction.

16. The Appellants argued that since they needed funds for their children's education costs, they had to obtain Loan C to 'purchase' or continue to own the Properties and the Subject CPS; otherwise they would have to sell them and would not have any rental income thereafter. The Appellants also submitted that the amount of loan borrowed in order to finance such 'continuous ownership' was a subjective decision based on one's preference and/or needs, which was a personal matter to the Appellants and the Respondent ought not interfere. Indeed, submitted by the Appellants, the proviso to section 42 does not state that the refinanced amount must be the same as that of the previous loan.

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17. We proceed on the basis of the ratio of the two earlier decisions of this Board in D103/89 and D50/96 which is not challenged. Since there is no dispute as to whether interest was incurred on money borrowed, the next question is to ascertain the purpose(s) for which the money was borrowed.

18. The Appellants could have maintained the then *status quo*, continued to own the Subject CPS and rent it out for a stream of rental income. They could have continued to deduct their interest expenses under Loan B attributable to the Subject CPS until it would have been fully paid up. However, all these were made not possible because of the changed circumstances of the Appellants in which they required funds for the education costs of their children and they might not have any other sources of funding than the Properties and the Subject CPS. The Appellants chose to re-mortgage the Properties and the Subject CPS so that sufficient fund (with reference to their estimate) could be obtained without disposing of the Properties and the Subject CPS. At best to the Appellants, we can only conclude that there existed dual purposes for borrowing Loan C: (a) to provide for the education costs of the Appellants' children; and (b) to maintain the ownership in, inter alia, the Subject CPS, so that the Subject CPS can continue to be rented out in return for income which is chargeable to property tax.

19. The Appellants acknowledged in their written submissions that their *estimate* of the annual costs and expenses for each child, including their tuition fees, boarding fees, airfares, local guardian and daily expenses, would be over \$400,000 and it would take 5 years for each child to complete up to the basic undergraduate course. That resulted in a total of about \$4,000,000 (\$400,000 x 2 x 5). The total figure of \$4,000,000 was derived from an estimate and may vary if there may be any increase in fees and/or possible inflation.

20. In such circumstances, we find that the approach adopted in D2/91 should be followed in apportioning the interest expenses.

21. The outstanding indebtedness regarding Loan B at the time Loan C was obtained was \$438,076, in which \$33,500 was attributable to the Subject CPS. We accept the Respondent's submission that according to D2/91 and in the absence of any contrary evidence, deduction of repayments to Loan C should be applied proportionately to that part of the loan applicable to maintaining the ownership of the Subject CPS and that part of the loan applicable to other purposes. Accordingly the interest paid during the year of assessment 2006/07 should be apportioned in the same ratio throughout the same period.

22. The total interest paid on Loan C in the year of assessment 2006/07 was \$242,526.13. The applicable ratio is \$33,500 to \$4,800,000. Hence the amount of allowable interest arrived at by apportioning the total interest paid in the ratio is:

$$\begin{aligned} & \$242,526.13 \times (\$33,500 / \$4,800,000) \\ & = \$1,692 \end{aligned}$$

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Each of the Appellants has a share, therefore, of \$846 as deductible interest expenses for the year of assessment.

Our decision

23. From the above analysis, we conclude that the Appellant fails to discharge the onus under section 68(4) in showing that the assessment stated in paragraph 1 is excessive or incorrect. Therefore, this appeal must be dismissed and the assessment is hereby confirmed.