

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D2/91

Personal assessment – rental income – deduction of interest on money borrowed – section 42(1) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), John C Broadley and Joseph S Brooker.

Date of hearing: 22 November 1990.

Date of decision: 8 April 1991.

The taxpayer applied for personal assessment and claimed to be allowed to deduct certain interest against rental income which was included in the personal assessment. The assessor refused to allow the interest to be deducted because he maintained that the interest was not payable on money borrowed for the purpose of producing that part of the total income of the taxpayer as provided in the proviso to section 42(1) of the Inland Revenue Ordinance. The taxpayer appealed to the Board of Review and gave evidence to the effect that the property in question had been exchanged for other property which was subject to a mortgage. In order to effect the exchange it had been necessary for him to repay the mortgage and to achieve this he had mortgaged the property which he was acquiring. The loan which he obtained on the property which he was acquiring was greater than that necessary to redeem the mortgage on the first property which the taxpayer was exchanging.

Held:

The assessment should be referred back to the Commissioner to enable the interest on that part of the loan which was required for the property exchange to be ascertained. The taxpayer had proved to the satisfaction of the Board that he had incurred interest on a loan which was necessary to enable him to earn the rental income which was being assessed.

Appeal allowed in part.

Jennifer Chan for the Commissioner of Inland Revenue.

Taxpayer in person.

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Decision:

This is an appeal by a taxpayer against a personal assessment to tax in which the Commissioner has refused to allow the deduction of certain interest which the Taxpayer claims should have been deducted. The facts are as follows:

1. The Taxpayer elected for personal assessment for the year of assessment 1986/87. Included in his assessable income for the year of assessment was rental income which he received in respect of a property which he owned ('the property'). During the same year of assessment the property was mortgaged to a bank and the Taxpayer paid interest to the bank.
2. The Taxpayer claimed a deduction of the amount of interest which he paid to the bank in respect of the money which was secured by the mortgage on the property. The assessor rejected this claim on the ground that the interest was not payable on any money borrowed for the purpose of producing that part of the total income of the Taxpayer as provided in the proviso of section 42(1) of the Inland Revenue Ordinance.
3. In addition to the property the Taxpayer either alone or in equal shares with his wife owned a substantial number of other properties ('the other properties') in respect of many of which he collected rental income and all of which were mortgaged to various banks for loans of various amounts. None of the other properties are the subject matter of this appeal.

At the hearing of the appeal before the Board of Review the Taxpayer appeared in person and briefly outlined his case to the effect that the interest had been paid and incurred by him in the production of the rental income which had been taxed. The representative for the Commissioner submitted that the monies borrowed by the Taxpayer on the security of the property had not been used to acquire the property and accordingly the interest was not deductible. She drew attention to the many other properties owned by the Taxpayer and his wife and the many other mortgages which he had and loans which he owed to banks. The crux of the dispute between the Taxpayer and the Commissioner related to the manner in which the Taxpayer had acquired the property. He had not purchased in the open market in the usual way but had acquired it by way of exchange. The Taxpayer had reserved his right to give evidence after the Board had ascertained the nature of the dispute and he proceeded to give evidence on his own behalf. The Board adopted the procedure which it has used in previous cases of assisting the Taxpayer by asking him non-leading questions which enable him to state his evidence-in-chief. Thereafter he was cross-examined by the representative for the Commissioner. The Board found the Taxpayer to be a truthful witness and accepted the evidence given by him.

In addition to the facts set out above, this Board finds the following additional facts from the evidence given by the Taxpayer:

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1. The property had originally been acquired by the Taxpayer from a developer with completion of the acquisition taking place in 1978.
2. In 1983 the Taxpayer entered into a deed of exchange with his mother whereby he exchanged the property for another property previously owned by his mother.
3. In March 1986 the Taxpayer entered into a second deed of exchange with his mother whereby he received back from his mother the property in exchange for another property which he transferred to her.
4. Immediately prior to the second deed of exchange the other property which the Taxpayer was transferring to his mother was subject to a mortgage which the Taxpayer had to repay before he could transfer the other property to his mother under the deed of exchange clear of encumbrances. To enable the Taxpayer to repay this existing mortgage he arranged to mortgage the property. Simultaneous with the second deed of exchange taking effect, the Taxpayer repaid his existing mortgage on the other property and mortgaged the property.
5. It was impossible for the Taxpayer to complete the transaction contained in the second deed of exchange without repaying the then existing mortgage on the other property which he was transferring to his mother free and clear of encumbrances and to achieve this, he borrowed money on the security of the property.
6. The sum required by the Taxpayer to repay the then existing mortgage on the other property which he was transferring was approximately \$300,000. The Taxpayer borrowed on the security of the property simultaneous with the acquisition of the sum of \$472,000 which was approximately \$172,000 in excess of the amount required by him to acquire the property.
7. The Taxpayer said in evidence that he obtained a larger loan than he required to exchange the other property with his mother so that he could take advantage of opportunities to acquire additional properties and he said that he did use the surplus for this purpose. However as it is not material to this appeal the Board does not make any findings of fact as to the additional moneys borrowed by the Taxpayer.
8. The Taxpayer in evidence said that he did not have available the exact amount of the mortgage loan that was required to effect the exchange of properties with his mother but that he could easily obtain the exact figure by referring to his solicitors and the bank.

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The representative for the Commissioner submitted that the loan obtained by the Taxpayer on the property had in fact been obtained subsequent to the second deed of exchange because it was an instalment loan and interest payments were payable on the first day of each month which was a few days subsequent to the date of the second deed of exchange. With due respect to the Commissioner and his representative we are unable to understand the logic of this submission. The dates of payment of instalments or interest are a matter of convenience to the parties to the mortgage and do not necessarily occur on the same numerical day of the month as the loan was made. Indeed it is often the case that a broken period will arise and be taken into account either at the commencement or the end of a mortgage period so that the instalment payments and interest are paid on the first day of a month. However in the present case we have the evidence of the land office record which shows that the date of the mortgage and the date of the deed of exchange are identical to each other. In such circumstances we can find no substance whatsoever in the submission made on behalf of the Commissioner in this regard and are of the view this issue should have been resolved prior to this appeal coming before the Board.

The Commissioner's representative and the Commissioner in his determination appear to have become confused because of the large number of the properties which the Taxpayer appears to have owned for rental or personal use. It is not for us to express any views regarding this because it is not the subject matter of this appeal. This appeal relates simply to the question of whether or not the Taxpayer is allowed to deduct interest on a loan which he says was incurred to enable him to earn rental income.

On the facts as we have found them approximately \$300,000 out of the total \$472,000 which the Taxpayer borrowed on the property when he received it from his mother was money borrowed by him to enable him to acquire the property. If he had not paid off the existing mortgage which he had on the property which he previously owned and which he transferred to his mother he could not have obtained the property free and clear of encumbrances or indeed at all. In these circumstances the interest which the Taxpayer has been required to pay on the moneys which he borrowed for the purpose of acquiring the property must be allowed to be deducted from his rental income and not be disallowed as it has been by the assessor. However the full amount of the interest on the mortgage loan of \$472,000 is not deductible because only approximately \$300,000 was used to acquire the property.

As the Taxpayer was not able to give us the exact sum when the case was heard but stated that he could easily do so by reference to his solicitors and his bankers it will be necessary for us to refer this matter back to the Commissioner so that the exact amount can be ascertained. Furthermore 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.

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As stated above this appeal only relates to the claim by the Taxpayer for a deduction of interest in respect of the moneys borrowed for the purpose of acquiring the property. Any surplus moneys which the Taxpayer borrowed do not relate to the property and as there is no claim before us in relation to other properties which the purchaser may or may not have purchased using the balance of the moneys it is not necessary for us to make any findings with regard thereto. In the course of the hearing we indicated to the representative for the Commissioner that the words in the proviso of section 42(1) which state that interest shall be deducted from 'that part of the total income arising from paragraph (a)' relates to the aggregate of all of the rental income and that if the rental income of a property were less than the amount of interest capable of being deducted, the balance of the interest could be deducted against the rental income from another property. On the facts before us this question does not arise because the balance of the interest in this case has not been claimed by the Taxpayer in the course of the hearing before us to be attributable to the production of rental income. Accordingly we make no ruling in this regard.

For the reasons given we order that the assessment appealed against be remitted back to the Commissioner to be reduced by the amount of interest paid by the Taxpayer in the year in question on that part of the loan which he obtained when he acquired the property by exchange from his mother which was necessary to repay the then existing loan on the property which he was transferring to his mother by way of exchange.