

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D50/96

Personal assessment – deduction of interest on mortgage loan – whether purpose of loan was to produce rental income – Inland Revenue Ordinance section 42(1) proviso.

Panel: Andrew Halkyard (chairman), William E Mocatta and Andrew Wang Wei Hung.

Date of hearing: 3 September 1996.

Date of decision: 4 October 1996.

The taxpayers, a husband and wife, jointly and individually owned three properties. To provide sufficient living area for their family, the taxpayers purchased Property C by mortgaging Properties B and C. Property B, which immediately prior to the purchase of Property C was used as the family residence, was then rented out. Property A was rented out at all times. The taxpayers, having elected to be taxed under personal assessment, sought to deduct the mortgage interest applicable in respect of a Property B. The Commissioner disallowed the deduction on the basis that the mortgage loan had been borrowed to acquire Property C in which the taxpayers resided and which did not therefore produce any income. The taxpayers appealed.

Held:

Under the proviso to section 42(1), interest payable on any money borrowed for the purpose of producing part of the total income may be deducted from that part of total income. The only issue was whether the money on which the interest had been paid had been borrowed for the purpose of producing income chargeable to property tax. The taxpayers' acknowledged 'purpose' in borrowing the funds had been to finance the purchase of Property C as a family residence in order to improve the family's living conditions. Although one *effect* or *consequence* was to create a rental stream when the use of Property B changed from self-residence to letting, it was not open to thereby conclude that the purpose of the taxpayers in borrowing money to purchase Property C had been to produce chargeable income.

Appeal dismissed.

Cases referred to:

D103/89, IRBRD, vol 6, 379
Mallalieu v Drummond [1983] 2 AC 861

Cheung Lai Chun for the Commissioner of Inland Revenue.

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Taxpayer in person.

Decision:

Mr X and Madam Y (hereafter called 'Mr X' and 'Madam Y' respectively and 'the Taxpayers' jointly) have appealed against the determination of the Commissioner to confirm the personal assessment and the additional personal assessment for the year of assessment 1993/94 raised on them as husband and wife. They claim that mortgage loan interest in the amount of \$41,844 should be deducted from their total income in the computation of tax.

The facts

The facts relevant to this appeal were not in dispute. They are as follows.

1. The Taxpayers own the following properties:

	Property	Date of Purchase	Purchase Cost	Share
Mr X	Property C	1-7-1993	1,600,000	50%
Madam Y	Property B	15-5-1987	430,500	100%
	Property A	20-6-1984	230,000	100%

2. The Taxpayers lived in Property B before Property C was acquired. After acquiring Property C they moved from Property B to Property C and leased Property B. At all relevant times Property A was leased.
3. The purchase of Property B was financed mainly by way of a mortgage loan from Company D. The mortgage was discharged sometime in 1990 or 1991. No mortgage was ever taken out to purchase Property A.
4. During the year ended 31 March 1994 Madam Y received the following amounts of rental income from letting out Property A and Property B.

\$

Property A	63,000
Property B	39,000

5. On the basis of the information disclosed in the Taxpayers' individual tax returns for the year of assessment 1993/94 and further information obtained from Madam Y, the assessor raised personal assessments on the Taxpayers

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which fully charged to tax the rental income disclosed in fact 4. The assessments did not allow any deduction for mortgage interest incurred by the Taxpayers (see facts 6 and 7).

6. The Taxpayers objected to the assessments at fact 5 on the basis that mortgage loan interest of \$41,844 should be deducted from their total income. The Taxpayers contended that because they paid mortgage interest on two of the three properties they owned and that they also earned rent chargeable to property tax, it would only be fair if they were allowed a deduction for the interest claimed. The amount of \$41,844 related to a mortgage loan provided to Mr X by Company E ('the Mortgagee'). The loan was taken out when Property C was acquired. Details of the loan and related mortgage are set out at fact 7.
7. When Mr X purchased Property C the bulk of the purchase price, \$1,440,000 of a total purchase price amounting to \$1,600,000, was borrowed from the Mortgagee. This loan was secured by way of a first legal charge for all moneys over the following properties and for the following amounts: \$740,000 against Property B and \$700,000 against Property C. The amount of interest of \$41,844 set out at fact 6 relates solely to the interest attributable to the amount secured by mortgage over Property B.
8. In its Credit Commitment Report, prepared prior to the approval of the mortgage loan, the Mortgagee stated that the purpose of the borrowing in the amount of \$1,440,000 was 'For home purchasing/self occupied for [Mr X's] son'.
9. On 15 February 1996 the Commissioner rejected the Taxpayer's objection and confirmed the assessments described at fact 5. In his determination, the Commissioner stated that:

'Insofar as relevant, mortgage loan interest can be deducted under personal assessment if it is payable on money borrowed for the purpose of producing rental income [chargeable to tax]. In the present case, it is quite clear that the interest claimed ... was payable on mortgage loans borrowed to acquire [Property C]. [Property C] was used by [the Taxpayers] as their residence and did not produce any income that had been included under personal assessment. Deduction for the interest should not therefore be allowed.'
10. On 2 March 1996 the Taxpayers appealed to the Board of Review against the Commissioner's determination. The grounds of appeal are as follows.

- 1. Brief description on family background**

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Originally we owned [Property A] with a gross area of 400 odd square feet and [Property B] with similar area ... which is a flat comprising two bedrooms and a sitting room. One property was for self-residence [Property B] while the other was for rental purpose. ... Since my three children are growing up, a flat of 400 odd square feet is really not enough for us to live. However, we are unable to afford the occupation of the above two properties as residence. [Madam Y] has suffered from complication such as diabetes and high blood pressure for many years. We are not allowed to do so in financial terms. If we swap the flat with a larger one, there will be no place for our children to live when they set up their own families in future. After consulting the family members, [Property C] was acquired at the market price of \$1,600,000 for self-residence in August 1993 in order to free us from the housing problems. The gross area of the flat is 610 square feet with three bedrooms and a sitting room and has an age of over 20 years.

2. Statement on details of loan

At that time, a deposit of 10% of the consideration (\$160,000) was paid in cash. Regarding the balance of 90% of the consideration (\$1,440,000), a loan of \$700,000 was obtained from [the Mortgagee] in the name of [Mr X] with the title deed of [Property B] as a pledge to cover the downpayment of [Property C]. It then became:

- | | |
|-----------------------------------|--------------------------------|
| (1) [Property C] (self-residence) | a loan of [\$700,000] borrowed |
| (2) [Property B] (rent out) | a loan of [\$740,000] borrowed |
| (3) [Property A] (rent out) | no loan borrowed |

At that time, the monthly rental for [Property B] was \$6,000 and that for [Property A] was \$5,600 (total \$11,600) ... On the other hand, the monthly instalments for [Property B and Property A totalled \$17,972]. We actually had to spend \$6,000 odd each month to cover the shortfall. The full amount of rental from [Property A] has been reported to [the IRD] for assessment every year. [Property C] was mortgaged for self-residence and instalment was paid every month. However, the statutory deduction of interest was not allowed by [the IRD]. Regarding the renting of [Property B], instalment was also paid every month and in fact there was no such thing as rental income as mentioned.

Since [Madam Y] has suffered from many illnesses and has lost the working ability, it is not easy to obtain loans from the bank. Besides, it is reasonable to borrow loans in the name of [Mr X] to purchase [Property C] for self-residence. Though [Property C] was purchased jointly with the eldest son, in fact all consideration and instalments were paid by us and the instalments were financed by the rental income.

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... In view of what has been said above, for a family possessing three properties like us, the interest incurred on none of the properties is allowed as a deduction. Is it fair?

The course of the Board hearing and the arguments of the parties

With the agreement of both parties, we accepted (subject to some minor changes) that the facts set out in the Commissioner's determination and in the Taxpayers' notice of appeal should form the basis of our decision. We have extracted the relevant facts above. The appeal, therefore, revolved around the respective arguments of the parties.

Mr X, who appeared for the Taxpayers, essentially relied upon the statements and arguments set out in his grounds of appeal (fact 10). He understood why he was unable to deduct the interest previously paid to Company D in respect of Property B (fact 3) -- because he was living in Property B at the relevant time. However, he argued that the facts of this appeal were different and that he should be able to deduct the interest paid to the Mortgagee -- because although he was living in Property C he was only seeking to deduct the interest referable to the mortgage loan secured over Property B and that during this time Property B was let to earn rental income. Mr X reiterated that he had never sought to deduct the interest referable to the mortgage loan secured over Property C.

Ms Cheung Lai-chun, who appeared for the Commissioner, supported the reasons set out in the Commissioner's determination at fact 9. Essentially, Ms Cheung argued that the purpose of the borrowing clearly was to finance the purchase of Property C in order to improve the Taxpayers' family living conditions. She contended that no deduction can be allowed for interest paid for a loan secured by an income producing asset where the amount was borrowed for a non-income producing purpose. Ms Cheung pointed out that at all times Property C was used by the Taxpayers as their residence. Deductibility for the interest in dispute does not, argued Ms Cheung, depend upon the nature of the security or, indeed, the existence of any security.

The statutory provision

The only provision of the Inland Revenue Ordinance relevant to this appeal is section 42(1) which states:

'(1) 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) *(Repealed)*

(ii) *in respect of the years of assessment commencing on or after 1 April 1983, the sum equivalent to the net assessable value [of land and buildings in Hong Kong] as ascertained in accordance with sections 5(1A) and 5B ...*

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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.'

Analysis

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.

The first two conditions are clearly satisfied in this case. The only issue for us to decide is whether the money on which the interest was paid was borrowed for the *purpose* of producing income chargeable to property tax (compare D103/89, IRBRD, vol 6, 379 at 383).

In analysing this issue our initial premise was simply to conclude that because the borrowed funds were used for the avowed intention of purchasing a residence (Property C) it could not be said that the Taxpayers' purpose was to borrow the funds to produce income chargeable to property tax (compare the Commissioner's decision at fact 9).

However, in the interest of examining all possible arguments for the Taxpayers (they were not professionally represented at the Board hearing) we also considered an alternative approach. In short, in view of their economic circumstances the Taxpayers only had two choices in financing the purchase of Property C: (1) sell Property B or (2) borrow the bulk of the purchase price, retain Property B to produce rental income, and then use that income to help make payments to the Mortgagee. Looked at in this way, it might be argued that the method of financing led to the creation of an income producing asset and that therefore the Taxpayers' purpose in borrowing from the Mortgagee was both to purchase a residence and to produce chargeable rental income.

After undertaking independent research, we could not discover any further Hong Kong cases dealing with the interpretation of the word 'purpose' in the context of the proviso to section 42(1). We therefore turned to the ordinary meaning of the word which is defined in the *Concise Oxford Dictionary* as:

'design of effecting something; thing that it is designed to effect; ... with deliberate intention'.

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This definition generally accords with the interpretation given by the courts to the meaning of ‘purpose’ in comparable taxation contexts (although the House of Lords decision in Mallalieu v Drummond [1983] 2 AC 861, a case involving a claim for deduction for the purchase of clothing by a barrister under a statutory provision which allowed expenses incurred wholly and exclusively ‘for the purposes of the trade’, indicates that evidence of purpose in a person’s mind should not exclude common sense inferences as to other unarticulated purposes).

Given, therefore, that ‘purpose’ generally relates to a person’s design or intention, it is clear in this case that the Taxpayers’ acknowledged purpose in borrowing the funds from the Mortgagee was to finance the purchase of Property C as a family residence in order to improve the family’s living conditions (fact 10). In light of authorities such as Mallalieu v Drummond we then considered whether there were sufficient inferences from the facts before us which would justify us departing from this conclusion. We could not find them. 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.

We note that our conclusion is supported objectively by the fact that the funds were indeed used to purchase Property C (fact 7), that Property C was a larger property than their previous residence (fact 10) and that the Taxpayer’s statement of purpose was made clear to the Mortgagee (fact 8). Furthermore, there is no evidence that the mortgage was taken out over Property B for any other reason than that the Taxpayer’s equity in Property C was insufficient security for the loan granted to, and used by, the Taxpayer to purchase Property C.

On the basis of the above analysis we conclude that the Taxpayers borrowed the whole of the funds from the Mortgagee for the purpose of purchasing Property C, which at all times was used as the Taxpayers’ residence. The funds were not borrowed for the purpose of producing chargeable rental income. It follows that the proviso to section 42(1) does not apply to allow the interest in dispute to be claimed as a deduction.

Before concluding, we should state that we sympathise with the Taxpayers in this case. They have two rental properties producing chargeable income but cannot presently deduct their mortgage interest payments. The answer would be different if they lived in Property B and leased Property C. Although it is no consolation to the Taxpayers, we can only state that tax is imposed upon what they did; it is not imposed upon what they could have done.

For the above reasons the appeal is dismissed.