Case No. D96/01

Profits tax – deduction for mortgage interest – section 42(1) of the Inland Revenue Ordinance ('IRO') – onus of proof – effect of self-serving assertions un-tested by cross examination.

Panel: Ronny Wong Fook Hum SC (chairman), Melville Thomas Charles Boase and Gregory Robert Scott Crichton.

Date of hearing: 13 August 2001.
Date of decision: 7 November 2001.

The appellants were co-owners of several properties. The appellants elected personal assessment and sought to deduct mortgage interest against the total assessable value of the four purchased properties. The appellants further claimed that two of their purchased properties were acquired for the purpose of producing rental income and they were therefore entitled to deduct their share of the mortgage interest from the date of acquisition of those properties. The Revenue allowed the claimed deduction on the mortgage interest according to the share of assessable value in respect of each property owned by the appellants and refused to allow deductions prior to the letting out of those properties.

Held:

1. By the express terms of section 42(1) of the IRO, the proviso only allows a deduction for interest payable on money borrowed for the purpose of producing that part of the total taxable property income which has been included for personal assessment under paragraph (a) for the relevant year of assessment. It does not allow a global deduction for interest payable against total taxable property income; even less does it allow a global deduction for interest payable against the total taxable income (D50/96, IRBRD, vol 11, 547 applied; D86/99, IRBRD, vol 14, 581, D2/91, IRBRD, vol 5, 532 considered).

2. In respect of the issue on whether or not the purpose of the acquisition of the properties was with the view of producing rental income, the onus of proof is on the appellants. The appellants did not attend the hearing to give viva voce evidence. The Board could not place any weight to the written submissions of the appellants which were self-serving assertions un-tested by cross examination. Base on the

evidence before the Board, the Board was not satisfied that the appellants have discharged the onus of proof resting upon them.

Appeal dismissed.

Cases referred to:

D2/91, IRBRD, vol 5, 532
D50/96, IRBRD, vol 11, 547
D86/99, IRBRD, vol 14, 581

Cheung Mei Fan for the Commissioner of Inland Revenue.
Eddy Pang Siu Kei of Messrs S K Pang & Co, Certified Public Accountants, for the taxpayers.

Decision:

Background

1. The Appellants ('Mr A' and 'Mrs A' respectively) are husband and wife.

2. By an agreement dated 8 May 1997, Mr A and his son purchased as joint tenants a flat at Housing Estate B ('Property 1') for $12,087,900.

(a) The purchase was financed in part by a mortgage loan of $8,400,000 extended by Bank C in favour of Mr A and his son. That loan was repayable by instalments. The first of such repayment took place on 9 July 1997. In the year of assessment 1998/99, Mr A and his son incurred further interest in servicing this loan.

(b) The purchase was completed on 23 February 1998.

(c) According to a receipt dated 1 March 1998, Property Agency D was handed over two keys in respect of this property.

(d) By a tenancy agreement dated 7 August 1998, Mr A and his son granted a tenancy in respect of Property 1 for one year yielding rent at the rate of $25,000 per month inclusive of management fee and government rates. This tenancy was however terminated prematurely by mutual consent with the tenant on 14 June 1999.

3. By an agreement dated 5 January 1998, Mr A, Mrs A and their son purchased as joint tenants a flat at Housing Estate E ('Property 2'), for $14,280,000.

(a) The purchase was completed on 1 May 1998. It was financed in part by a loan extended by Bank F of $7,800,000. The three of them paid interest in respect of this loan.

(b) By a receipt dated 10 May 1998, Property Agency D acknowledged due receipt of one key for Property 2.

(c) By a tenancy agreement dated 29 January 1999, Mr A, Mrs A and their son let Property 2 out in favour of a tenant for one year yielding rent at $50,500 per month inclusive of management fee and government rates. The total rent derived from this tenancy in the year of assessment 1998/99 was $88,346.

4. In the year of assessment 1998/99, Mr and Mrs A each had a 50% interest in a shop in District G ('Property 3'). Property 3 was rented out and the total rental income derived therefrom in the year of assessment 1998/99 was $2,520,000.

5. In the year of assessment 1998/99, Mr A was also the 100% owner of an office in Centre H ('Property 4').

(a) The total rental obtained by Mr A from Property 4 in the year of assessment 1998/99 was $96,000.

(b) In the same year he incurred mortgage interest in the sum of $30,357 in respect of this property.

6. The position of Mr A may be summarised as follows:

Property	**Share of assessable value in respect of the property** $	**Share of interest paid** $
Property 1	67,516	269,632
Property 2	23,559	36,379
Property 3	1,008,000	--
Property 4	76,800	30,357
	1,175,875	336,368

7. The position of Mrs A may be summarised as follows:

Property	**Share of assessable value in**	**Share of interest paid**

	respect of the property $	 $
Property 2	23,559	36,379
Property 3	1,008,000	--
	1,031,559	36,379

8. Mr and Mrs A elected personal assessment for the year of assessment 1998/99.

9. There are two issues between the parties:

(a) Mr A claims that he is entitled to deduct mortgage interest totalling $336,368 against the total assessable value of $1,175,875. The Revenue allowed him deduction of $67,516 in respect of Property 1; $23,559 in respect of Property 2 and $30,357 in respect of Property 4 totalling $121,432. Mrs A claims that she is entitled to deduct mortgage interest totalling $36,379 against her share of total assessable value of $1,031,559. The Revenue allowed her to deduct $23,559 in respect of Property 2.

(b) Mr and Mrs A claim that Properties 1 and 2 were acquired for the purpose of producing rental income. They are therefore entitled to deduct their share of the mortgage interest from the date of acquisition of those properties. In their case, the applicable period for Property 1 would be between 5 March 1998 and 5 March 1999 and the applicable period for Property 2 would be between 1 May 1998 and 31 March 1999. The Revenue refused to allow deductions prior to the letting out of those properties, that is, 15 August 1998 in respect of Property 1 and 1 February 1999 in respect of Property 2.

The relevant provisions in the IRO

10. Section 5 in Part II of the IRO provides that:

'*(1) Property tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person being the owner of any land or buildings ... wherever situate in Hong Kong and shall be computed at the standard rate on the net assessable value of such land or buildings ... for each such year.*

...

(1A) In subsection (1), "net assessable value" means the assessable value of land or buildings ... ascertained in accordance with section 5B –

(a) ...

(b) less –

(i) where the owner agrees to pay the rates in respect of the land or buildings ... those rates paid by him; and

(ii) an allowance for repairs and outgoings of 20% of that assessable value after deduction of any rates under subparagraph (i).'

11. Section 5B in Part II of the IRO provides:

' (1) This section shall apply to any year of assessment commencing on or after 1 April 1983.

(2) The assessable value of land or buildings ... for each year of assessment shall be the consideration, in money or money's worth, payable in that year to ... the owner in respect of the right of use of that land or buildings...'.

12. Section 42 in Part VII of the IRO provides:

' (1) For the purposes of this Part the total income of an individual for any year of assessment shall, subject to subsection (8), 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 where an individual is a joint owner or co-owner of property, that individual's share of net assessable value shall be computed by apportioning the value ascertained in accordance with section 5(1A) or 5B –

(a) in the case of joint ownership, between the joint owners equally; and

(b) in the case of ownership in common, between the owners in common each in proportion to his share in such ownership;

(b) the net assessable income of the individual for that year of assessment; and

(c) subject to subsection (1A), the assessable profits of the individual for that year of assessment computed in accordance with Part IV:

(d) (Repealed 17 of 1989 s. 10)

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'.

The case law

13. In D2/91, IRBRD, vol 5, 532, the taxpayer exchanged a property of his with a property of his mother's. The former property was subject to a mortgage. 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 which he obtained on the property which he was acquiring was greater than what was necessary to redeem the mortgage on his former property. The Board of Review allowed the taxpayer's claim to the extent of what was necessary to redeem the mortgage. The Board of Review indicated that:

> '*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 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.'*

These observations are obviously not part of the ratio in D2/91. They do not purport to lay down any definitive principle.

14. In D50/96, IRBRD, vol 11, 547, the taxpayers owned three properties. Property A was rented out at all times. Property B was once the family residence. In order to provide sufficient

living areas for the family, the taxpayers acquired Property C. That acquisition was financed by the mortgage of Properties B and C. The Board there stated that:

> '*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.'*

On the facts before them, the Board of Review rejected the taxpayers' claim.

15. In D86/99, IRBRD, vol 14, 581, the taxpayer purchased the subject property in March 1997 for long-term investment to generate rental income. The purchase was financed by way of a mortgage. During the year of assessment 1997/98, the taxpayer received no rental income from the subject property but he paid total mortgage interest of $207,321. The taxpayer owned two other properties during the same year of assessment. Both were let fully furnished and produced rental income. The taxpayer sought to deduct the mortgage interest in respect of the subject property against the rental income from the other two properties. The taxpayer 'contended that the proviso to section 42(1) does not specify that one can look at the separate rental income for each individual property; rather it specifies the total income of an individual for any year of assessment' – an argument similar to the one deployed by Mr and Mrs A in this case. The Board of Review rejected that argument and pointed out in relation to the proviso to section 42(1) that:

> '*5. The Taxpayer argues, correctly, that an individual's total taxable income is aggregated for personal assessment purposes. But it does not follow that his total interest expenses should then be deducted against his total income. Rather, under personal assessment, to qualify for a deduction interest must satisfy the applicable statutory provision, namely, either the proviso to section 42(1)...*
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> *6. The proviso to section 42(1) allows a deduction from: "that part of the total income arising from paragraph (a) [paragraph (a) speaks of net assessable value for property tax purposes] 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 the provisions relating to profits tax]". (emphasis added)

7. By its express terms the proviso only allows a deduction for interest payable on money borrowed for the purpose of producing that part of the total taxable property income which has been included for personal assessment under paragraph (a) for the relevant year of assessment. It does not allow a global deduction for interest payable against total taxable property income; even less does it allow a global deduction for interest payable against the total taxable income.

8. ...

9. We conclude that in the year of assessment 1997/98 the Taxpayer did not derive any taxable income from Property 1. Therefore, whatever interpretation is placed upon the phrase "that part" in the proviso to section 42(1), the interest paid by the Taxpayer to Bank B on the Property 1 mortgage in the year of assessment 1997/98 cannot be deducted under that provision. Simply put, in the year of assessment 1997/98 the money borrowed did not produce any – or any part – of the taxable property income assessed to the Taxpayer under section 42(1)(a).'

Our decision

16. D86/99 is directly in point. No convincing argument has been presented on behalf of Mr and Mrs A as to why this should not be followed. This authority is determinative of the first issue. On the basis of the reasoning outlined in that case, we rule against Mr and Mrs A on the first issue.

17. As far as the second issue is concerned, the onus is on Mr and Mrs A to satisfy us that Properties 1 and 2 were purchased with the view of producing rental income. They did not attend the hearing to give any *viva voce* evidence. We have been furnished with a written submission prepared by Mr Pang, the tax representative of Mr and Mrs A. The written submission is a document drafted with care. It referred to oral confirmations which Mr Pang received from various persons such as Mr and Mrs A's son and Property Agency D as to circumstances surrounding the acquisition of these two properties. We regret that we cannot place any weight to these self-serving assertions un-tested by cross examination. Mr Pang also placed reliance on the key receipts issued by Property Agency D. We agree with the Revenue's submissions that these documents are of little assistance. They make no reference to the instructions given to Property Agency D. The tendering

of the keys could be for sale or for letting. For these reasons, we are not satisfied that Mr and Mrs A have discharged the onus of proof resting upon them in relation to the second issue.

18. For these reasons, we dismiss the appeal for Mr and Mrs A.