

Case No. D49/09

Personal assessment – allowable deduction – mortgage interests – sections 42(1) and 68(4) of Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), James Mailer and Ng Man Sang Alan.

Date of hearing: 10 December 2009.

Date of decision: 19 January 2010.

The Taxpayer appealed against the additional personal assessments for the years of assessment 2000/01 to 2005/06. The issue concerned the amounts of mortgage interests that were incurred on money borrowed for the purpose of producing rental income from a property ('the Property') and whether they were allowable deductions for the said years of assessment.

The Taxpayer purchased the Property for a consideration of \$6,200,000. He obtained a loan of \$5,580,000 from Company E to finance the purchase of the Property and used his own funds, in the amount of \$790,500, to pay the balance of the purchase price and the stamp duty. He then obtained a further loan of \$5,580,000 from Company F to replace the loan from Company E; and further obtained a loan of \$9,000,000 from Bank G of which \$5,580,000 was used to replace the loan from Company F and \$3,420,000 was deposited into his personal bank account, which was intended for his other personal use. The Taxpayer claimed that it was permissible for him to refinance the amount of \$790,500 put up by himself for purchase of the Property by applying \$790,500 out of the proceeds from the Bank G loan for such refinancing purpose.

Held:

1. The Board concluded that only \$5,580,000 out of the Bank G loan of \$9,000,000 was used to purchase the Property and only interest on this part of the loan was an allowable deduction.
2. The Board also accepted that, as no contrary evidence was given, deduction of repayments to the Bank G loan should be applied proportionately to that part of the loan applicable to the Property and that part of the loan applicable to the Taxpayer's intended personal use.

Appeal dismissed.

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Cases referred to:

D103/89, IRBRD, vol 6, 379

D50/96, IRBRD, vol 11, 547

Federal Commissioner of Taxation v Roberts & Smith [1992] 23 ATR 494

Wharf Properties Limited and CIR, Inland Revenue Appeal No 2 of 1993

Zeta Estates Limited and CIR, CACV 191 of 2005

Zeta Estates Limited and CIR, FACV 15 of 2006

Andrew Wong of Messrs W M Sum & Co for the taxpayer.

Wong Pui Ki and Chan Man On for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by Mr C ('the Taxpayer') in respect of the additional personal assessments for the years of assessment 2000/01 to 2005/06. The Deputy Commissioner of Inland Revenue ('the Deputy Commissioner') by virtue of a Determination dated 6 August 2009 ('the Determination') upheld the relevant additional personal assessments in respect of the relevant years of assessment 2000/01 to 2005/06.

The issue

2. The issue for the Board to decide is the amounts of mortgage interests that were incurred on money borrowed for the purpose of producing rental income and should these be allowable deductions for the years of assessment 2000/01 to 2005/06.

Agreed facts

3. The parties were able to agree the facts upon which the Determination was arrived at.

4. We now set out the relevant facts with which the parties were able to agree and therefore, we find these as facts:

'(1) [Mr C] has objected to the additional Personal Assessments for the years of assessment 2000/01 to 2005/06 raised on him. [Mr C] claims that certain interest expenses paid by him in financing his income generating property should be allowed for deduction.

(2) (a) On 31 May 1993, [Mr C] purchased a property at [Residential Estate D], Hong Kong ["the Property"] at a consideration of \$6,200,000.

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- (b) To finance the acquisition, [Mr C], with the Property as security, obtained a loan of \$5,580,000 from [Company E].
- (3) (a) On 23 May 1994, [Mr C], with the Property as security, obtained a loan of \$5,580,000 ["Loan A"] from [Company F]. Loan A was repayable by 5 yearly instalments with the first repayment due on 31 May 1999.
- (b) On the same date, the loan referred to in Fact (2)(b) with an outstanding principal of \$5,580,000 was fully repaid and the relevant legal charge was discharged.
- (4) (a) On 29 April 1997, [Mr C], with the Property as security, obtained a loan of \$9,000,000 ["Loan B"] from [Bank G].
- (b) On the same date, Loan A with an outstanding principal of \$5,580,000 was fully repaid and the relevant legal charge was discharged.
- (c) According to the annual statements of Loan B issued by [Bank G] for the years ended 31 March 2001 to 2006, the following amounts of interest were paid on Loan B:

<u>Year of assessment</u>	<u>Interest paid</u>
	\$
2000/01	606,804.24
2001/02	297,991.60
2002/03	170,488.16
2003/04	146,416.03
2004/05	128,514.65
2005/06	173,469.62

- (5) On divers dates, [Mr C] submitted his Tax Returns – Individuals for the years of assessment 2000/01 to 2005/06 in which he, among other things,
 - (a) elected for Personal Assessment for the years of assessment 2000/01 to 2005/06;
 - (b) declared rental income from the Property and claimed deduction for interest payments to produce income from the Property as follows:

<u>Year of assessment</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>
	\$	\$	\$	\$	\$	\$

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Rental income	<u>636,000</u>	<u>636,000</u>	<u>408,580</u>	<u>444,000</u>	<u>427,000</u>	<u>420,000</u>
Interest payments	<u>377,567</u>	<u>297,991</u>	<u>170,488</u>	<u>146,416</u>	<u>128,515</u>	<u>173,470</u>

(6) On divers dates, the Assessor raised on [Mr C] Property Tax assessments and Personal Assessments for the years of assessment 2000/01 to 2005/06 as follows:

(a) Property Tax assessments

Year of assessment	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>
	\$	\$	\$	\$	\$	\$
Rental Income	636,000	636,000	408,580	444,000	427,000	420,000
[Fact (5)(b)]						
Less: Allowance	<u>(127,200)</u>	<u>(127,200)</u>	<u>(81,716)</u>	<u>(88,800)</u>	<u>(85,400)</u>	<u>(84,000)</u>
Net Assessable Value ["NAV"]	<u>508,800</u>	<u>508,800</u>	<u>326,864</u>	<u>355,200</u>	<u>341,600</u>	<u>336,000</u>

(b) Personal Assessments

(i) Years of assessment 2000/01 to 2002/03

Year of assessment	<u>2000/01</u>		<u>2001/02</u>		<u>2002/03</u>	
	[Mr C's]		[Mr C's]		[Mr C's]	
	<u>Total</u>	<u>share</u>	<u>Total</u>	<u>share</u>	<u>Total</u>	<u>share</u>
	\$	\$	\$	\$	\$	\$
Income - Properties	508,800	508,800	729,600	508,800	543,270	326,864
[NAV in Fact (6)(a)]						
Salaries	<u>5,861,670</u>	<u>5,303,850</u>	<u>7,181,830</u>	<u>6,610,750</u>	<u>9,288,491</u>	<u>8,730,450</u>
Total income	6,370,470	5,812,650	7,911,430	7,119,550	9,831,761	9,057,314
Less: Deductions -						
Interest payable	(377,567)	(377,567)	(518,791)	(297,991)	(386,894)	(170,488)
[Fact (5)(b)]						
Charitable donations	(39,824)	(35,964)	(44,075)	(44,075)	(31,200)	(23,200)
Contributions to recognized retirement schemes	-	-	-	-	(12,000)	-
Reduced total income	<u>5,953,079</u>	<u>5,399,119</u>	<u>7,348,564</u>	<u>6,777,484</u>	<u>9,401,667</u>	<u>8,863,626</u>
Tax Payable thereon ¹	<u>892,961</u>	<u>809,868</u>	<u>1,102,284²</u>	<u>1,016,623²</u>	<u>1,410,250</u>	<u>1,329,544</u>

Note:

1 : [Mr C's] share of Tax Payable thereon

$$= \text{Tax Payable thereon} \times \frac{\text{[Mr C's] share of reduced total income}}{\text{Reduced total income}}$$

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2 : By virtue of the Tax Exemption (2001 Tax Year) Order, the Tax Payable thereon for the year of assessment 2001/02 was subsequently reduced from \$1,102,284 ([Mr C's] share being \$1,016,623) to \$1,099,284 ([Mr C's] share being \$1,013,856).

(ii) Years of assessment 2003/04 to 2005/06

Year of Assessment	2003/04		2004/05		2005/06	
	Total	[Mr C's] share	Total	[Mr C's] share	Total	[Mr C's] share
	\$	\$	\$	\$	\$	\$
Income - Properties [NAV in Fact (6)(a)]	576,000	355,200	562,400	341,600	536,153	336,000
Salaries	<u>12,103,590</u>	<u>11,546,175</u>	<u>13,235,570</u>	<u>12,699,275</u>	<u>14,658,780</u>	<u>14,130,900</u>
Total income	12,679,590	11,901,375	13,797,970	13,040,875	15,194,933	14,466,900
<u>Less: Deductions -</u>						
Interest payable [Fact (5)(b)]	(325,063)	(146,416)	(297,354)	(128,515)	(373,623)	(173,470)
Charitable donations	(49,400)	(42,800)	(54,200)	(46,400)	(80,950)	(74,150)
Elderly residential care expenses	-	-	-	-	(29,360)	-
Reduced total income	<u>12,305,127</u>	<u>11,712,159</u>	<u>13,446,416</u>	<u>12,865,960</u>	<u>14,711,000</u>	<u>14,219,280</u>
Tax Payable thereon ¹	<u>1,907,294</u>	<u>1,815,384</u>	<u>2,151,426</u>	<u>2,058,554</u>	<u>2,353,760</u>	<u>2,275,085</u>

Note:

1 : [Mr C's] share of Tax Payable thereon

$$= \text{Tax Payable thereon} \times \frac{\text{[Mr C's] share of reduced total income}}{\text{Reduced total income}}$$

[Mr C] did not object to the above assessments.

(7) The Assessor conducted a review on the interest deduction for the year of assessment 2004/05. In response to the Assessor's enquiries, W M Sum & Co ["the Representative"] claimed the following:

- (a) The Property was financed by a staff loan, Loan A, granted by [Mr C's] then employer when the Property was purchased. After cessation of the employment, [Mr C] obtained a loan from [Bank G], Loan B, to replace Loan A.
- (b) The first repayment instalment of Loan A was due on 31 May 1999. Thus, the amount of the outstanding principal of Loan A at the time of redemption in 1997 was still \$5,580,000.

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- (c) The value of the Property had increased substantially in 1997 since it was purchased. As [Mr C] had need for funds for personal use in addition to repaying the staff loan, he borrowed an amount in excess of the purchase price of the Property. The amount of Loan B in excess of the cost of the Property was applied for other personal use and had since been repaid.
- (d) Throughout the year of assessment 2004/05, the whole amount of Loan B outstanding (reducing from \$5,461,575.01 to \$4,731,935.26) was to finance the Property with a cost of \$6,200,000. Interest of \$128,514.65 incurred thereon was therefore deductible against rental income derived from the Property.
- (8) The Assessor was of the view that only a portion of the interest paid on Loan B could be allowable for interest deduction. The allowable interest payable should be reduced in proportion to the extent to which Loan B was applied for paying off Loan A. The Assessor then raised on [Mr C] additional Personal Assessment for the year of assessment 2004/05 as follows:

	<u>Total</u>	<u>[Mr C's] share</u>
	\$	\$
Reduced total income previously assessed [Fact (6)(b)(ii)]	13,446,416	12,865,960
<u>Add: Interest payable disallowed</u> [\$128,515 ¹ - \$79,678 ²]	<u>48,837</u>	<u>48,837</u>
Reduced total income	<u>13,495,253</u>	<u>12,914,797</u>
Tax Payable thereon	2,159,240	2,066,368 ³
<u>Less: Tax already charged</u>	<u>(2,151,426)</u>	<u>(2,058,554)</u>
Additional Tax Payable thereon	<u>7,814</u>	<u>7,814</u>

Note:

- 1 : Interest payable previously allowed [Fact (6)(b)(ii)].
 2 : Computation of allowable interest payable:

$$\begin{array}{r}
 \text{Interest on Loan B} \quad \times \quad \frac{\text{Outstanding principal of Loan A at the time of redemption}}{\text{Original loan amount of Loan B}} \\
 \\
 = \$128,514.65 \quad \times \quad \frac{\$5,580,000 \text{ [Fact (4)(b)]}}{\$9,000,000 \text{ [Fact (4)(a)]}} \\
 \text{[Fact (4)(c)]} \\
 = \$79,678
 \end{array}$$

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3 : [Mr C's] share of Tax Payable thereon

$$\begin{aligned} &= \text{Tax Payable thereon} \times \frac{\text{[Mr C's] share of reduced total income}}{\text{Reduced total income}} \\ &= \$2,159,240 \times \$12,914,797 \div \$13,495,253 \end{aligned}$$

- (9) The Representative, on behalf of [Mr C], objected to the 2004/05 additional Personal Assessment in Fact (8) on the ground that interest charges totalling \$128,515 were incurred for the purpose of producing part of [Mr C's] total income for the year of assessment in question and that there was no basis for apportioning the interest charges incurred in the year ended 31 March 2005 according to the ratio of the amount of the loan obtained for the purpose of financing [Mr C's] income generating property to his total borrowings in 1997 in disallowing part of the interest incurred in the year of assessment 2004/05.
- (10) In amplification of the grounds of objection, the Representative put forth the following contentions:
- (a) "Our client purchased the property concerned at a cost of \$6,200,000. It was financed by a combination of his own funds and outside loans. The amounts funded by himself and that from outside loans fluctuate throughout the years as our client chooses having regard to his own financial resources and other investment opportunities."
- (b) "Throughout the year of assessment in question, borrowing to finance the income generating property ranged from \$5,461,575.01 to \$4,731,935.26, with the balance of between \$738,424.99 and \$1,468,064.74 provided by his own funds. The external borrowing was wholly utilized in funding the property costing our client \$6,200,000, with the shortfall met by our client's own resources. There is no basis at all to disallow a portion of interest incurred on borrowings that were wholly utilized in financing a property which generated taxable income."
- (c) "[O]ur client took out a loan of \$5,580,000 from [Company F] to finance his property from which rental income was derived. In response to a demand to repay this loan, a loan from [Bank G] was obtained to refinance the loan from [Company F] in April 1997. An additional loan amount of \$3,420,000 was also obtained to finance our client's other activities."
- (d) "This additional amount of \$3,420,000 has since been repaid, together with part of the loan taken out in 1997 from [Bank G] to refinance the original loan of \$5,580,000. The amount of loan

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outstanding during the basis period decreased from \$5,490,420.61 as at 1st April 2004 to \$4,731,935.26, from which interest charges amounting to \$128,514.65 were paid.”

- (e) “Our client can understand that had no part of the loan of \$9,000,000 been repaid and the amount of interest incurred in the basis period arose from a loan of \$9,000,000, apportionment of interest allowable for deduction as you have proposed would have been proper and acceptable. But the clear fact is that the excess amount borrowed had been repaid and the amount of loan outstanding during the basis period on which interest deduction claimed of \$128,515 arose was less than the original amount of the loan which was borrowed to finance the income producing property. The whole amount of \$128,515 was interest payable on money borrowed for the purpose of producing rental income from the property and should therefore be deducted from our client’s total income in accordance with section 42(1) of the Inland Revenue Ordinance [‘the Ordinance’].”
- (f) “Our client may have at times borrowed amounts in excess of the cost of the property concerned for other purposes, but the excess amounts had since been repaid, interest incurred on the excess borrowings had not been claimed as a deduction. The excess borrowings have no relevance to the interest deduction claimed.”
- (g) “By disallowing a portion of interest incurred based on the excess borrowing taken out in the past is to demand a mandatory simultaneous repayment of the loan to finance the income generating property when the portion of loan taken out to finance other venture were repaid, to deny our client’s liberty to employ his own financial resources as he so chooses, and to deny that he has a choice of repaying the excess amount borrowed to finance other ventures but retaining sufficient amount to finance his income generating properties.”
- (h) “That the taxpayer has this freedom of choice is clear from the judgment of P Chan J (as he then was) in *Wharf Properties Ltd v. Commissioner of Inland Revenue* [1995] 1 HKLR 347 [‘the Wharf Case’] at page 369, where he said:

‘...There is nothing to prevent a person who is in possession of a large capital from borrowing from a bank or financial institution to commence or continue his business instead of using his own capital. The purpose of the loan is to use it as capital in his business and that is what he has done. He may have a private motive to serve in borrowing, but that is not important. If by

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borrowing he can have a tax or other advantage in that he can claim deductions under the provisions of the Ordinance that is perfectly permissible and is entirely a commercial decision for him.’ ”

- (i) “Our client...is convinced of the inappropriateness of the basis on which his income has been assessed and intends to seek out the principles that are applicable as expounded in the Courts, which clearly indicate that the entire amount of interest incurred is deductible.”

- (11) In subsequent correspondence with the Assessor, the Representative advised that for the years of assessment 2000/01 to 2003/04, [Mr C] might have inadvertently under/overclaimed mortgage loan interest attributable to the cost of the Property of \$6,200,000 and submitted that the amount of attributable interest should be as follows:

<u>Year of Assessment</u>	<u>Interest claimed and allowed</u> ¹	<u>Attributable Interest</u> ²	<u>(Under) / Over claimed</u>
	\$	\$	\$
2000/01	377,567	477,131	(99,564)
2001/02	297,991	251,185	46,806
2002/03	170,489	159,926	10,562
2003/04	146,416	146,387	29

Note:

1 : Per Facts (5)(b) and (6)(b).

2 : Attributable interest for each month is computed by the formula:

$$\text{Interest for the month} \times \frac{\$6,200,000}{\text{Opening balance of Loan B}^*}$$

* Where the opening balance of Loan B < \$6,200,000, the denominator = \$6,200,000

- (12) The Assessor maintained the view that the allowable interest should be reduced in proportion to the extent to which Loan B was applied for paying off Loan A and raised on [Mr C] additional Personal Assessments for the years of assessment 2000/01, 2001/02, 2002/03, 2003/04 and 2005/06 as follows:

- (a) Years of assessment 2000/01 to 2002/03

Year of assessment	<u>2000/01</u>		<u>2001/02</u>		<u>2002/03</u>	
	<u>Total</u>	<u>[Mr C's] share</u>	<u>Total</u>	<u>[Mr C's] share</u>	<u>Total</u>	<u>[Mr C's] share</u>

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	\$	\$	\$	\$	\$	\$
Reduced total income previously assessed [Fact (6)(b)(i)]	5,953,079	5,399,119	7,348,564	6,777,484	9,401,667	8,863,626
<u>Add: Interest payable disallowed¹</u>	<u>1,348²</u>	<u>1,348²</u>	<u>113,236³</u>	<u>113,236³</u>	<u>64,785⁴</u>	<u>64,785⁴</u>
Reduced total income	<u>5,954,427</u>	<u>5,400,467</u>	<u>7,461,800</u>	<u>6,890,720</u>	<u>9,466,452</u>	<u>8,928,411</u>
Tax Payable thereon	893,164	810,071 ⁵	1,116,270	1,030,842 ⁵	1,419,967	1,339,261 ⁵
<u>Less: Tax already charged</u>	<u>(892,961)</u>	<u>(809,868)</u>	<u>(1,099,284)</u>	<u>(1,013,856)</u>	<u>(1,410,250)</u>	<u>(1,329,544)</u>
Additional Tax Payable thereon	<u>203</u>	<u>203</u>	<u>16,986</u>	<u>16,986</u>	<u>9,717</u>	<u>9,717</u>

Note:

1 : Interest payable disallowed

$$= \text{Interest previously allowed [Fact (6)(b)(i)]} - (\text{Interest paid [Fact (4)(c)]} \times \$5,580,000 [\text{Fact (4)(b)}] \div \$9,000,000 [\text{Fact (4)(a)}])$$

$$2 : \$377,567 - (\$606,804.24 \times \$5,580,000 \div \$9,000,000) = \$1,348$$

$$3 : \$297,991 - (\$297,991.60 \times \$5,580,000 \div \$9,000,000) = \$113,236$$

$$4 : \$170,488 - (\$170,488.16 \times \$5,580,000 \div \$9,000,000) = \$64,785$$

5 : [Mr C's] share of Tax Payable thereon

$$= \frac{\text{Tax Payable thereon} \times [\text{Mr C's}] \text{ share of reduced total income}}{\text{Reduced total income}}$$

(b) Years of assessment 2003/04 and 2005/06

Year of Assessment	<u>2003/04</u>		<u>2005/06</u>	
	<u>Total</u> \$	<u>[Mr C's] share</u> \$	<u>Total</u> \$	<u>[Mr C's] share</u> \$
Reduced total income previously assessed [Fact (6)(b)(ii)]	12,305,127	11,712,159	14,711,000	14,219,280
<u>Add: Interest payable disallowed¹</u>	<u>55,638²</u>	<u>55,638²</u>	<u>65,919³</u>	<u>65,919³</u>
Reduced total income	<u>12,360,765</u>	<u>11,767,797</u>	<u>14,776,919</u>	<u>14,285,199</u>
Tax Payable thereon	1,915,918	1,824,008 ⁴	2,364,307	2,285,632 ⁴
<u>Less: Tax already charged</u>	<u>(1,907,294)</u>	<u>(1,815,384)</u>	<u>(2,353,760)</u>	<u>(2,275,085)</u>
Additional Tax Payable thereon	<u>8,624</u>	<u>8,624</u>	<u>10,547</u>	<u>10,547</u>

Note:

1 : Interest payable disallowed

$$= \text{Interest previously allowed [Fact (6)(b)(ii)]} - (\text{Interest paid [Fact (4)(c)]} \times \$5,580,000 [\text{Fact (4)(b)}] \div \$9,000,000 [\text{Fact (4)(a)}])$$

$$2 : \$146,416 - (\$146,416.03 \times \$5,580,000 \div \$9,000,000) = \$55,368$$

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3 : $\$173,470 - (\$173,469.62 \times \$5,580,000 \div \$9,000,000) = \$65,919$

4 : [Mr C's] share of Tax Payable thereon

$$= \frac{\text{Tax Payable thereon}}{\text{Reduced total income}} \times \frac{\text{[Mr C's] share of reduced total income}}{\text{Reduced total income}}$$

- (13) The Representative, on behalf of [Mr C], objected to the additional Personal Assessments in Fact (12) on the ground that part of the interest charges incurred for the purpose of producing [Mr C's] income from the Property had been disallowed and was not in accordance with the attributable interest provided in Fact (11).
- (14) The Assessor advised [Mr C] that the Wharf Case was not relevant to his case and explained to him that unless contrary evidence was given, the repayments of Loan B should be applied proportionately to that part of the loan applicable to finance the Property and to that part for personal use. Thus, interest payment should also be apportioned in the same ratio. The Assessor then invited [Mr C] to withdraw the objections or provide further information to substantiate his contention that the repayments made were first applied to reduce that part of the loan for personal use.
- (15) [Mr C] refused to withdraw his objections. In response, the Representative, on behalf of [Mr C], put forth the following arguments:
- (a) "With due respect, we do not agree with your postulation that [the Wharf Case] is not relevant to the present case. We are of the opinion that the principle established in [the Wharf Case] is a general principle that has pervasive application in the administration of [the Ordinance]. Its application is not restricted to Section 16(a) of [the Ordinance] only but is equally applicable to Section 42(1) of [the Ordinance]. This is so because the subject matter of these two sections, viz. '...sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits...' in Section 16(a) and '...the amount of any interest payable on any money borrowed for the purpose of producing that part of the total income...' in Section 42(1) are identical in substance."
- (b) "Such being the case, it is unreasonable and without basis to say that the deduction of repayments should be applied proportionately to the part of the loan applicable to the property and also to that part of the loan applicable for other purposes. So doing would in effect deny our client's liberty to employ his own financial resources as he so chooses."

- (c) “The facts of the case is clear, and so is the law. Our client purchased the property in 1993 for HK\$6,200,000. This created a financial burden of HK\$6,200,000 that he needed to finance, which he satisfied partly by his own funds and partly by outside borrowing. As long as the property is retained by our client, he has to have the means to satisfy this financial burden of HK\$6,200,000. This financial burden will be eliminated or reduced only if the property or part thereof is sold. To satisfy this financial burden, our client may choose to put up his own funds, to borrow from outside, or a mixture of both, subject to commercial considerations.”
- (d) “If [our client] chooses to put up part of his own funds and to borrow a part from outside, interest incurred from outside borrowing is deductible against his income. If commercial circumstances are such that he was able to borrow and did borrow in excess of this financial burden, interest incurred on the borrowing over and above this financial burden of HK\$6,200,000 would not be deductible as it would not be incurred for the production of taxable income. Therefore, under such circumstances, interest incurred would need to be apportioned, with the cost of the property, that is, the financial burden assumed to generate income as the numerator and the amount of total borrowing as the denominator.”
- (e) “In apportioning interest charges incurred, the numerator does not change, as the financial burden assumed in generating income does not change unless the property or part thereof is sold, but the denominator changes with the actual amount borrowed, being the amount on which interest charges to be apportioned are based. Thus when amounts in excess of the purchase cost is borrowed, the bigger the amount borrowed, the portion of interest incurred deductible for tax purpose becomes smaller, and vice versa. Interest apportionment varies according to the amount of loan outstanding.”
- (f) “Proper application of Section 42(1) of [the Ordinance] in situations where the amount borrowed is in excess of the purchase cost of the property requires interest to be apportioned according to the ratio of purchase cost to actual loan amount outstanding at the relevant time, and not apportioned based on the ratio at a specific time in the past, without giving effect to the actual amount outstanding during the year of assessment. In situation where the amount borrowed is less than the purchase cost the property, no interest apportionment is necessary.”

- (g) “Our client maintains that it is his prerogative to arrange his financial affairs as he chooses and as dictated by his commercial consideration. Nowhere in [the Ordinance] directs him as to how he applies his repayment. The simple fact remains that for as long as he owns the property, he has the need to finance it to the extent of HK\$6,200,000. In 2000/01 to 2003/04, the years in which our client borrowed in excess of HK\$6,200,000, interest charges have been apportioned to eliminate excess interest as deductions. During the years ended [31st March 2005 and 31st March 2006, he borrowed between HK\$5,490,420.61 and HK\$3,982,531.88] against his property and put up the rest to meet this financing need. Evidence of the cost of the property and the amount outstanding during the years have already been provided to you”
- (h) “Our client’s obligation to [Bank G] is clearly set-out in the mortgage deed executed by our client in favour of [Bank G] ... Nowhere in the said mortgage deed stipulates how the repayment was to be applied. It is up to our client in deciding how the repayment is to be applied. Our client’s clear affirmation and his continuing ownership of the property unequivocally demonstrated that the repayments were first applied to relieve financial burdens other than that relating to the property.”
- (16) The annual statements of Loan B showed that Loan B was repayable by monthly instalments up to July 2000 and then by bi-weekly instalments starting from August 2000. The instalments were used for interest payment and principal repayment of Loan B. Up to the year ended 31 March 2006, no special partial repayment, other than regular instalments, of Loan B was made.’

5. We note that in her submissions, Ms Wong on behalf of Deputy Commissioner was also prepared to agree the following additional facts:

‘In addition to the cost of Property of \$6,200,000, [Mr C] also paid stamp duty of \$170,500 to complete the purchase. Total cost of the Property to [Mr C] was therefore \$6,370,500, with \$5,580,000 borrowed from [Company E] and \$790,500 put up by himself.’

The evidence

6. The Taxpayer gave evidence before us.

7. He purchased a property at Residential Estate D, Hong Kong (‘the Property’) for a consideration of \$6,200,000. The Property was for his family residence. He initially obtained a loan of \$5,580,000 from Company E. He was an employee of Company E. He

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also paid a further of \$790,500 which included the balance of the purchase price of \$620,000 as well as stamp duty in the sum of \$170,500 in order to complete the purchase.

8. In around May 1994, he left employment with Company E and in turn, joined Company H. Pursuant to his employment terms with Company H, he was able to obtain a further loan of \$5,580,000 from Company F. Company F was a related company to Company H and with the proceeds of the loan, he repaid the Company E advance.

9. He told us that his family moved out the Property in around July 1996 and he therefore rented out the Property in order to generate rental income.

10. He left employment with Company H in March 1997. He indicated to us that these were uncertain times for him and his family. He had to take steps to repay the loan of \$5,580,000 due to Company F. He was taking up new employment with Company J. He approached Bank G in April 1997 to arrange for the refinancing of the Property. However, he was somewhat uncertain as to his future employment and therefore took steps and obtained a facility of \$9,000,000 from Bank G which would ensure that he had sufficient sums to pay back the Company F loan and the balance of \$3,420,000 was deposited into his personal bank account.

11. When asked for what this sum was for, he said it was 'a cushion' to make sure that he had sufficient funds available to support himself and his family as he was under probation with his new employer.

12. On cross-examination by Ms Wong, he confirmed that he did indeed make a repayment to Company F in the sum of \$5,580,000. He also confirmed he did not instruct Bank G on how any repayments were to be applied in respect of his borrowings in the sum of \$9,000,000.

13. Hence, it is quite clear that there is no dispute between the parties that when the Property was purchased in 1993, the purchase price was \$6,200,000 and this was funded by an initial loan of \$5,580,000 from Company E and the balance from the Taxpayer's own resources. It was also agreed that the loan of \$5,580,000 from Company E was later replaced by a loan from Company F. In 1997, the Taxpayer obtained a further loan of \$9,000,000 from Bank G and at that time, he repaid the Company F loan which was outstanding in the sum of \$5,580,000. In short, the difference between the parties is as follows:

- (a) The Taxpayer's case is that \$6,370,500 out of the Bank G loan was applied in financing the Property. However, the IRD's case is that only \$5,580,000 out of the Bank G loan was applied in financing the Property and hence, borrowed for the purpose of producing rental income.
- (b) The Taxpayer in his written submissions asserts that the proceeds of the Bank G loan was applied as follows:

		\$
(i)	Pay off the loan from Company F	5,580,000
(ii)	Refinance the advance made by the Taxpayer to fund part of the purchase price (\$620,000) and stamp duty of the Property transaction (\$170,500)	790,500 ('the Sum')
(iii)	Advance to the Taxpayer	<u>2,629,500</u>
	Total:	<u>9,000,000</u>

- (c) Therefore, it is clear that there was common ground that the \$5,580,000 under the Bank G loan was applied to replace the loan from Company F and there is no dispute that the \$5,580,000 out of the Bank G loan was borrowed for the purpose of producing rental income from the Property.
- (d) There is also no dispute that \$2,629,500 out of the Bank G loan was borrowed for other purposes and the interest incurred on this part of the loan is not deductible.
- (e) Therefore, what has to be established is the purpose for which the remaining \$790,500 was borrowed. The Taxpayer asserts that the Sum was applied to refinance the previous advance made by the Taxpayer for the purchase of the Property. Hence, on this basis, he contends that the Sum was also borrowed for the purpose of producing rental income. The IRD submits that the Sum was not borrowed for the purpose of producing rental income but for other purposes.

The relevant statutory provisions

14. Section 42(1) of the Inland Revenue Ordinance ('IRO') provides that:

'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 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.'

15. Section 68(4) of the IRO provides that:

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

16. Ms Wong in her submissions drew our attention to the relevant cases that deal with the purpose for which the money was borrowed. She referred us to D103/89, IRBRD, vol 6, 379, there, it was held that under section 42(1) of the IRO, the Taxpayer must demonstrate that the interest was paid on monies borrowed for the purpose of producing chargeable income. The Board stated at page 383 that:

‘What has to be established under the proviso of section 42 is the purpose for which the money was borrowed. it is then up to the Taxpayer to demonstrate that the withdrawals nevertheless were for the purpose of producing chargeable income under section 42(1)’

17. In D50/96, IRBRD, vol 11, 547, the Board stated at page 552 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.’*

18. Again, in that case, the Board after stating that the first two conditions are satisfied, went on to analyse the issue of whether the money was borrowed for the purpose of producing chargeable property income. In dismissing the taxpayer’s appeal, the Board stated at page 553 that:

‘Given, therefore, that “purpose” 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 ... 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.’

19. Ms Wong also drew our attention to various principles set out in Federal Commissioner of Taxation v Roberts & Smith [1992] 23 ATR 494 (*‘Roberts & Smith’*). This is an Australian case concerning deduction of interest under section 51(1) of the Income Tax Assessment Act 1936. She also drew our attention to the Australian Taxation

Ruling TR95/25. In short, her position was that following the decision of Full Federal Court in Roberts & Smith, the Federal Commissioner of Taxation of Australia issued a Taxation Ruling on the issue of deductions of interest under the relevant provisions of the Australian Act. In short, she submitted that this Ruling recognizes the application of the ‘refinancing principle’ in Roberts & Smith to common law partnerships and extends its application to companies. It also rules that the ‘refinancing principle’ has no application to joint owners of investment property which does not constitute a business and is not applicable to individuals. The Ruling states as follows:

8. *The “refinancing principle” in Roberts and Smith has no application to joint owners of investment property which are not common law partnerships*
9. *..... the “refinancing principle” in Roberts and Smith applies only where a partnership borrows to refund capital invested by partners (by way of a contribution to capital, a loan, or a share of any accumulated and undistributed realised profits which could be treated as having been distributed and lent back) or where one form of borrowing replaces another. Hill J makes it very clear (..... ATR at 505-506) that reference to capital in this context is a reference to the capital of a partnership in the **partnership law sense**, that is, the “original partnership capital in the Lord Lindley sense”.*
10. *The joint owners of an investment property who comprise a partnership for tax purposes only in relation to the property cannot “withdraw” partnership capital and have no right to the “repayment of capital invested” in the sense in which those concepts are used by Hill J in Roberts and Smith*
11. *..... it is inappropriate to describe a borrowing by the joint owners of investment property, which does not constitute a business, as a refinancing of funds employed in a business.*

.....
19. *It is a well established principle of law that an individual cannot deal with and in particular cannot lend money to her/himself. It follows that where an individual carries on a business alone she/he cannot contribute capital to or lend money to such a business in such a way as to create a legal liability of the business to the individual in respect of the funds contributed or lent. The principles in Roberts and Smith cannot, therefore, apply to individuals.*

.....’

Discussion

20. Hence, as can be seen above, we need to look carefully as to what is to be established for the purpose for which the remaining \$790,500 was borrowed. Having considered the evidence as a whole and having looked at all matters, it is quite clear that it is unequivocal in the evidence given to us by the Taxpayer that the refinancing of the Property by virtue of the \$9,000,000 loan from Bank G, he was repaying \$5,580,000 out of the Bank G loan to Company F and in turn, he accepted in his evidence that the balance of \$3,420,000 was paid into his personal bank account as 'a cushion'. The Taxpayer in his evidence asserted that he was 'recouping' his investment of \$790,500 made in respect of the Property and therefore he was left with surplus funds of \$2,629,500 for other use. However, in our view, this was not the case. We accept that the sum of \$790,500 was not borrowed for the purpose of producing rental income but clearly, it was for other purposes. We accept the submissions put forward by Ms Wong in respect of this matter:

- (a) There was no evidence before us showing that there was an advance made by the Taxpayer to himself for the purchase of the Property.
- (b) Again, there was no evidence showing that the Sum was applied to repay such an advance.
- (c) We accept that it is a well-established principle of law that an individual cannot deal with and in particular cannot lend money to himself.
- (d) To purchase the Property, the Taxpayer paid, from his own resources \$620,000 representing 10% of the purchase price and \$170,500 for stamp duty. It is clear that he obtained external borrowing to finance the balance of the purchase price of \$5,580,000. Hence, we accept that it will be inappropriate to describe the \$620,000 and \$170,500 (\$790,500) paid by the Taxpayer for purchasing the Property as an advance from him. The evidence does not support this. It is clear that he simply paid for what he purchased.
- (e) In our view, the evidence was unequivocal, indeed in his witness statement and in cross-examination, the Taxpayer again made it perfectly clear and he confirmed that \$5,580,000 of the loan proceeds was used to repay the Company F loan and the entire balance of \$3,420,000 was deposited into his personal bank account.
- (f) Hence, we have no difficulties in accepting the submission of Ms Wong that the entire amount of \$3,420,000 was obtained to serve only one purpose, that is, to ensure that it provided additional funds to the Taxpayer for what he called 'a cushion' for his intended personal use.

21. Mr Wong also submitted that it is entirely permissible for the Taxpayer to refinance the amount of \$790,500 put up by himself for purchase of the Property in 1993 by applying \$790,500 out of the proceeds from the Bank G loan for such refinancing purpose.

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He relies on:

- Inland Revenue Appeal No 2 of 1993 - Wharf Properties Limited and CIR;
- CACV 191 of 2005 – Zeta Estates Limited and CIR; and
- FACV 15 of 2006 – Zeta Estates Limited and CIR.

However, in our view, these cases are not really relevant to the facts before us. One needs to look very carefully as to exactly what the Taxpayer did:

- (a) He obtained the loan of \$5,580,000 from Company E to finance the purchase of the Property and used his own funds to pay the balance of the purchase price and the stamp duty.
- (b) He then obtained a further loan of \$5,580,000 from Company F to replace the loan from Company E; and
- (c) He obtained a loan of \$9,000,000 from Bank G of which \$5,580,000 was used to replace the loan from Company F and \$3,420,000 was deposited into his personal bank account.

22. The only evidence before us was that the acknowledged use of the additional fund of \$3,420,000 was for his other personal use. Hence, we have no difficulties in coming to the conclusion that only \$5,580,000 out of the Bank G loan of \$9,000,000 was used to purchase the Property and only interest on this part of the loan was an allowable deduction. Finally, we also accept Ms Wong's submissions that as no contrary evidence was given, deduction of repayments to the Bank G loan should be applied proportionately to that part of the loan applicable to the Property and that part of the loan applicable to the Taxpayer's intended personal use.

Conclusion

23. Having therefore considered all the submissions and the authorities put before us, we come to the conclusion that the Determination of the Deputy Commissioner was correct and as such, we dismiss the appeal.