



**Inland Revenue Department**  
The Government of the Hong Kong Special Administrative Region  
of the People's Republic of China

**DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

**NO. 3 (REVISED)**

**PROFITS TAX**

**APPORTIONMENT OF EXPENSES**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued on 29 December 1989.

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Commissioner of Inland Revenue

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# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

## No. 3 (REVISED)

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## INTRODUCTION

Section 16(1) of the Inland Revenue Ordinance provides that in ascertaining the assessable profits for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred in the production of profits chargeable to tax.

2. Generally, an outgoing or expense is an allowable deduction if it is incurred in producing chargeable profits. The words “to the extent to which” signify that an outgoing or expense may be apportioned if it is only partly incurred to produce chargeable profits. In *CIR v. Cosmotron Manufacturing Co. Ltd.* 4 HKTC 562, Lord Nolan at the Privy Council observed that the phrase “for the purposes of the trade” adopted in the United Kingdom Income and Corporation Taxes Act 1988 has generally been interpreted in a manner consistent with the words “in the production of profits”.

## THE PRINCIPLES

3. In *Ronpibon Tin (NL) v. FCT* 4 AITR 236, it was recognized that two kinds of expenditure require apportionment. The first is expenditure in respect of a matter where distinct and severable parts are devoted to making profits and other parts are devoted to some other end. The second kind of apportionable expenditure is a single outlay that serves both the profit making purpose and some other purpose indifferently.

4. Godfrey J agreed in *Anthony Patrick Fahy trading as A.P. Fahy & Co. v. CIR* 3 HKTC 695 that if an outgoing or expense had a dual purpose, partly of a domestic or private nature and partly for business purpose, it was not allowable to the extent that the outgoing or expense was a domestic or private character. He ruled that there could not be any sensible apportionment of medical expenses if those elements of the purpose could not be distinguished and the expense was one indivisible matter.

5. In *CIR v. Hang Seng Bank Ltd.* 3 HKTC 351, Lord Bridge said that if a taxpayer derived profits partly within Hong Kong and partly outside Hong Kong, the gross offshore profits should be scaled down to bear their fair share of the general expenses of the business.

6. In an apportionment, the objective is to find a basis which is reasonable and equitable. Whilst the method adopted by an Assessor is open to objection and appeal, the taxpayer has to adduce primary documents in support that the expenditure was truly incurred in the production of chargeable profits. Ledgers are secondary and not primary documents per Chu J in *SO Kai-tong, Stanley trading as Stanley So & Co. v. CIR 6 HKTC 38*.

## **SPECIFIC EXPENDITURES**

7. Research and development payments or expenditures are apportioned under section 16B(2) where the relevant payments or expenditures are made or incurred outside Hong Kong and the trade is carried on partly in and partly out of Hong Kong. Expenditures on patent rights are apportioned under section 16E(2) where the rights are purchased partly for use in and outside Hong Kong. The deduction allowable will be determined after having regard to the extent of the use in Hong Kong. Apportionment of expenditure on prescribed fixed assets is required by section 16G(2) where the asset is partly used in the production of chargeable profits.

## **INLAND REVENUE RULES**

8. Rules 2A, 2B and 2C of the Inland Revenue Rules provide the methods for apportionment of expenses in general, interest and management expenses in relation to the holding of share investments. Under Rules 2A, 2B and 2C, apportionment should be made on a basis that is most reasonable and appropriate in the circumstances of the case. Apportionment can be based on turnover, gross profit, income or assets.

9. The following methods adopted in practice are largely based on Rules 2A, 2B and 2C:

- (a) If trading profits are derived partly within Hong Kong and partly outside Hong Kong, expenses directly attributable to the profits arising outside Hong Kong are to be disallowed and an apportionment will be made of such expenses as are partly one and partly the other. The basis of such

apportionment may be on turnover or gross profit or such basis as is most appropriate to the activities of the trade.

- (b) If profits are derived from trading and also from share investments in the form of dividends, then -
  - (i) interest on money borrowed and used for the purpose of acquiring the share investments is not allowable for deduction; and
  - (ii) administration and general expenses as applicable to the receipt of the non-taxable dividends are allowable for deduction unless the extent of activities involved in the management and supervision of the investment portfolio and the collection of dividends is relatively appreciable.
- (c) Apart from any other profit earning activities, if the person is engaged in share dealing, then -
  - (i) no attempt is made to split any interest paid in respect of the share investments and the whole sum is allowed as against the profits arising from the buying and selling of stocks and shares and no portion is treated as applicable to the earning of the non-taxable profits from dividends; and
  - (ii) a small fraction of such expenses in supervision and management will normally be disallowed as applicable to the earning of the non-taxable dividends since the portfolio in these case, which would involve time and expense, is large.
- (d) Where there is a substantial investment portfolio, which would involve a degree of supervision and management as well as clerical and accounting records, it is a question of ascertaining the direct expenses and of allocating a proportion of the management, clerical and general expenses properly

attributable to those activities. Unless a more suitable basis is available, Rule 2C provides for taking a percentage of the total cost of the portfolio as the measure of the disallowable expenses. The percentage is not to exceed -

- (i) 1/8% where the investments are held at least partly for share dealing purposes;
- (ii) 1/2% in other cases.