



Inland Revenue Department  
Hong Kong

## **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

### **NO. 8 (REVISED)**

#### **PROFITS TAX**

#### **LOSSES**

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 20 July 1983.

LAU MAK Yee-ming, Alice  
Commissioner of Inland Revenue

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# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

## No. 8 (REVISED)

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## **INTRODUCTION**

Following the legislative amendments and a number of court decisions concerning the treatment of losses in recent years, it is considered appropriate to update our Practice Notes to incorporate the new statutory provisions and court cases, and to explain the practice adopted by the Inland Revenue Department in ascertaining and setting off the tax losses of businesses.

## **STATUTORY PROVISIONS**

2. Section 19C of the Inland Revenue Ordinance (the Ordinance) deals with the treatment of losses arising from a trade, profession or business for the year of assessment 1975/76 and subsequent.

3. Section 19D states that losses are computed in the same way and for the same basis period as assessable profits for that year of assessment would have been computed. It follows, therefore, that the provisions of sections 18B and 18E apply in deciding the year of assessment in which an allowable loss arises. Further, only losses arising in Hong Kong from the carrying on of a trade, profession or business in Hong Kong are allowable for set off against assessable profits. This is put beyond doubt by the provisions of section 19C(6)(d).

4. Section 18F provides that depreciation allowances under Part VI are deductible in arriving at the amount of assessable profits of a person “to the extent to which the relevant assets are used in the production of the assessable profits”. It further provides that where the amount of depreciation allowances made under Part VI exceeds the person’s assessable profits, as increased by any balancing charge, the amount of such excess is deemed to be a loss of that person for that year of assessment.

5. Sections 19CA and 19CB, which apply from the year of assessment 1998/99 onwards, provide for the set off of unabsorbed losses from normal trading receipts and concessionary trading receipts.

6. Section 20AD stipulates that losses arising from the exempt transactions carried on by an offshore fund cannot be used to set off against its future assessable profits. Reference can be made to Departmental Interpretation and Practice Notes No. 43 for the operation of the relevant rules.

## **TREATMENT OF LOSSES – SECTION 19C**

### ***Individuals***

7. Section 19C(1) provides that if an individual sustains a loss in carrying on a trade, profession or business, such loss can be carried forward for set off against his assessable profits from that same trade, etc., in subsequent years of assessment. This provision only applies where the individual has not elected for personal assessment for the year of assessment in which the loss was incurred.

### ***Partnerships with Individuals as partners***

8. Section 19C(2) deals with the treatment of losses incurred by a partnership in which one or more of the partners are individuals. Any loss incurred by such a partnership is apportioned among the partners in accordance with their profit or loss sharing arrangement during the basis period concerned (see section 22A). The amount allocated to a partner who is an individual is available for carry forward and set off against his share of the partnership profits from that same business for subsequent years of assessment. As with section 19C(1), this provision is also subject to the partner not having elected personal assessment for that year of assessment.

9. That is to say, the losses of a partnership are individual to the partners, they are not losses of the partnership and cannot be set off against future partnership profits:

### **Example 1**

A, B and C are carrying on a business in partnership. A is entitled to an annual salary of \$90,000 and the balance of the profits or loss is divided equally.

The partnership prepares its accounts to 31 December each year and its results are:

Year ended 31 December 2007	Loss	(\$120,000)
Year ended 31 December 2008	Profits	\$120,000

The loss of the partnership business for the year of assessment 2007/08 (basis period – year ended 31 December 2007) is to be allocated among the partners. The loss attributable to each partner is carried forward and set off against his share of partnership profits for the year of assessment 2008/09.

Year of assessment 2007/08

	<u>Salary</u>	<u>Balance</u>	<u>Sub- total</u>	<u>Reallocation of A's "surplus"</u>	<u>Share of the partnership loss</u>
	\$	\$	\$	\$	\$
A	90,000	(70,000)	20,000	(20,000)	-
B	-	(70,000)	(70,000)	10,000	(60,000)
C	-	(70,000)	(70,000)	10,000	(60,000)
	<u>90,000</u>	<u>(210,000)</u>	<u>(120,000)</u>		<u>(120,000)</u>

If B and C do not elect for personal assessment, their share of the partnership loss, i.e. \$60,000 each, will be carried forward for set off against their share of profits from the partnership in subsequent years.

Year of assessment 2008/09

	<u>Salary</u>	<u>Balance</u>	<u>Share of partnership profits</u>	<u>Set off Share of partnership loss brought forward</u>	<u>Share of partnership loss carried forward</u>
	\$	\$	\$	\$	\$
A	90,000	10,000	100,000	-	-
B	-	10,000	10,000	(60,000)	(50,000)
C	-	10,000	10,000	(60,000)	(50,000)
	<u>90,000</u>	<u>30,000</u>	<u>120,000</u>		<u>(100,000)</u>

If A does not elect for personal assessment for the year of assessment 2008/09, profits tax is payable on the \$100,000 profits apportioned to him and a notice of assessment reflecting this will be issued to the partnership in accordance with section 22(1). If A elects for

personal assessment, his total income will include his share of the partnership profits of \$100,000.

10. Where an individual has sustained a loss or has incurred a share of loss in a partnership and has elected for personal assessment, the amount of the loss shall be dealt with under personal assessment.

### ***Corporations or bodies of persons***

11. Sections 19C(4) and (5) apply to a corporation or “a person who is not an individual, a partnership or a corporation”. Though the definition of “person” in section 2 includes a “trustee” or a “body of persons”, section 19C(6)(e) specifically deals with the treatment of losses sustained by a trustee (see paragraph 16 below). Hence, sections 19C(4) and (5) are mainly for corporations or bodies of persons.

12. Section 19C(4) provides that the loss arising from a trade, etc., shall be set off firstly against the corporation’s or person’s assessable profits for the same year of assessment. These assessable profits include the corporation’s or person’s share of the assessable profits of any partnership of which it is a partner. If the loss is not wholly set off, the balance is carried forward for set off against the corporation’s or person’s assessable profits (including where appropriate, its share of the assessable profits of any partnership) for subsequent years until fully absorbed.

13. Section 19C(5) deals with the situation in which a corporation or person is trading in a partnership and the partnership sustains a loss. The corporation or person can set off its share of the partnership loss against its assessable profits for the same year of assessment. To the extent that the loss is not set off, it is carried forward to subsequent years and set off, first against the corporation’s or person’s share of profits from the partnership and then against its own assessable profits for that year. Unlike section 19C(4), this section does not provide for the set off of a corporation’s or person’s share of loss in a partnership against its share of profits in another partnership.

14. A loss sustained by a corporation can be used to set off the corporation’s share of assessable profits from a partnership even though that partnership did not exist at the time the corporation incurred the loss.

15. Example 2 shows how losses are set off under sections 19C(4) and (5):

**Example 2**

A Limited carries on a trade on its own account. It is also a partner in a partnership business, entitled to a 50% share in the profits or loss of the partnership.

The results of A Limited are:

Year ended 31 December 2006	Loss	(\$70,000)
Year ended 31 December 2007	Profits	\$100,000
Year ended 31 December 2008	Profits	\$50,000

The results of the partnership business are:

Year ended 31 December 2006	Profits	\$160,000
Year ended 31 December 2007	Loss	(\$240,000)
Year ended 31 December 2008	Profits	\$200,000

The tax position of A Limited:

Year of assessment 2006/07

<u>Own business</u>		<u>Partnership business</u>	
	\$		\$
Adjusted loss	(70,000)	Share of profits (50% of \$160,000)	80,000
Set off by		Set off of	
Share of partnership profits under section 19C(4)	<u>70,000</u>	Loss from own business under section 19C(4)	<u>(70,000)</u>
Loss carried forward	<u>NIL</u>	Share of profits chargeable to profits tax	<u>10,000</u>

Year of assessment 2007/08

<u>Own business</u>		<u>Partnership business</u>	
	\$		\$
Assessable profits	100,000	Share of loss (50% of \$240,000)	(120,000)
Set off of Share of partnership loss under section 19C(5)	<u>(100,000)</u>	Set off by Profits from own business under section 19C(5)	<u>100,000</u>
Net assessable profits	<u>NIL</u>	Unabsorbed loss carried forward	<u>(20,000)</u>

Year of assessment 2008/09

<u>Own business</u>		<u>Partnership business</u>	
	\$		\$
Assessable profits <sup>(1)</sup>	<u>50,000</u>	Share of profits (50% of \$200,000)	100,000
		Set off of Unabsorbed loss under section 19C(5) <sup>(1)</sup>	<u>(20,000)</u>
		Share of profits chargeable to profits tax	<u>80,000</u>
		Unabsorbed loss carried forward	<u>NIL</u>

- <sup>(1)</sup> The unabsorbed partnership loss brought forward of \$20,000 has to be set off against A Limited's share of partnership profits of \$100,000 first under section 19C(5). Therefore, no loss is available to A Limited for set off against the assessable profits from its own business.

***Trustees***

16. Section 19C(6)(e) deals with the treatment of losses incurred by a trustee who carries on a trade, profession or business in his capacity as a trustee. Such losses are only available for carry forward and set off against the assessable profits of the trust for subsequent years arising from the particular trade, etc., in which the losses were incurred. This provision makes it clear that the losses of a trust are not available for set off against the profits of another trust administered by the same trustee; neither are they available for set off against any profits the trustee may derive in his personal capacity.

### ***Personal Assessment***

17. If an individual has elected for personal assessment, section 42(2)(b) provides that his business loss or share of loss incurred in the year shall be deducted from his total income. The amount of loss exceeding total income is to be carried forward and set off against the total income for future years of assessment until such amount is wholly set off (see sections 42(5)(a)(i) and (b)(i)).

#### **Example 3**

During the year of assessment 2008/09, Mr. A, an individual who is single, has both income and business loss. Under personal assessment, his loss will be set off as follows:

	\$
Total income	100,000
Business loss	<u>(120,000)</u>
Unabsorbed loss carried forward under personal assessment to the next year of election	<u>20,000</u>

18. In the case of a joint election under section 41(1A), the unutilized current year business loss of an individual is used to set off against the spouse's total income. Any excess business loss will be carried forward to the next year of personal assessment election to set off firstly against the total income of the individual and then, if still not totally absorbed, against the total income of the spouse for that year (see sections 42(5)(a)(ii) and (b)(ii)). Reference can be made to paragraph 58 and Appendix B of Departmental Interpretation and Practice Notes No. 18 for further details of the transfer of losses between spouses in personal assessment.

#### ***Limitations on loss relief***

19. Section 19C(6) makes it clear that a loss cannot be set off more than once and that the total amount set off against assessable profits is not to exceed the amount of the loss.

## **UNABSORBED LOSSES FROM NORMAL AND CONCESSIONARY TRADING RECEIPTS**

### ***Cross set off***

20. Sections 19CA and 19CB provide for the cross set off of unabsorbed losses from normal trading receipts and concessionary trading receipts. They apply from the year of assessment 1998/99 onwards. As defined in section 19CA(5), “concessionary trading receipts” means the trading receipts and other sums in respect of which assessable profits are chargeable to tax at rate specified in section 14A (i.e. qualifying debt instruments) or 14B (i.e. qualifying reinsurance business of an insurance corporation), and “normal trading receipts” means the trading receipts and other sums in respect of which assessable profits are chargeable to tax at the rate specified in Schedule 1 or 8. For this purpose, profits or loss derived from normal trading receipts are referred to as “normal profits or loss”, and profits or loss derived from concessionary trading receipts are referred to as “concessionary profits or loss”.

### ***Adjustment factor***

21. As the two streams of profits are taxed at different rates, it is necessary to apply an adjustment factor to the profits or loss to be set off. The adjustment factor is the ratio, which the normal and concessionary tax rates bear to each other. Thus for the year of assessment 2008/09, the adjustment factor is 2,

i.e.,  $\frac{16.5\%}{8.25\%}$  for corporations;  $\frac{15\%}{7.5\%}$  for persons other than corporations.

The operations of sections 19CA and 19CB are further explained below.

### ***Same business and same year of assessment – Section 19CA***

22. Section 19CA deals with the cross set off of normal profits or loss and concessionary profits or loss within the same year of assessment for the same business. Section 19CA(2) applies when a taxpayer has unabsorbed concessionary loss and normal profits whilst section 19CA(3) applies when a taxpayer has unabsorbed normal loss and concessionary profits. The operation of this section under different scenarios is illustrated in Examples 4 to 7 below:

**Example 4 – Normal Profits exceed Concessionary Loss / Factor, Section 19CA(2)(a) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Profit / (loss) <sup>(1)</sup>	10,000	<u>(18,000)</u>
Reduced by		
Concessionary loss divided by the adjustment factor (i.e. \$18,000 ÷ 2)	<u>(9,000)</u>	<u>18,000</u>
Assessable profits <sup>(2)</sup>	<u>1,000</u>	
Unabsorbed loss <sup>(3)</sup>		<u>NIL</u>

- <sup>(1)</sup> Section 19CA(2)(a) applies as the amount of concessionary loss does not exceed the amount of normal profits as multiplied by the adjustment factor (i.e. \$18,000 ≤ \$10,000 x 2).
- <sup>(2)</sup> The assessable profits from normal trading receipts shall be taxed at the normal tax rate.
- <sup>(3)</sup> The unabsorbed loss from concessionary trading receipts shall be deemed to be nil.

**Example 5 – Normal profits do not exceed Concessionary Loss / Factor, Section 19CA(2)(b) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Profit / (loss) <sup>(1)</sup>	<u>10,000</u>	(24,000)
Reduced by		
Normal profits multiplied by the adjustment factor (i.e. \$10,000 x 2)	<u>(10,000)</u>	<u>20,000</u>
Unabsorbed loss <sup>(2)</sup>		<u>(4,000)</u>
Assessable profits <sup>(3)</sup>	<u>NIL</u>	

- <sup>(1)</sup> Section 19CA(2)(b) applies as the amount of concessionary loss exceeds the amount of normal profits as multiplied by the adjustment factor (i.e. \$24,000 > \$10,000 x 2).
- <sup>(2)</sup> The unabsorbed loss from concessionary trading receipts shall be carried forward for set off under sections 19C and 19CB.
- <sup>(3)</sup> The assessable profits from normal trading receipts shall be deemed to be nil.

**Example 6 – Normal Loss does not exceed Concessionary Profits / Factor, Section 19CA(3)(a) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Profit / (loss) <sup>(1)</sup>	<u>(10,000)</u>	24,000
Reduced by		
Normal loss multiplied by the adjustment factor (i.e. \$10,000 x 2)	<u>10,000</u>	<u>(20,000)</u>
Assessable profits <sup>(2)</sup>		<u>4,000</u>
Unabsorbed loss <sup>(3)</sup>	<u>NIL</u>	

- (1) Section 19CA(3)(a) applies as the amount of normal loss does not exceed the amount of concessionary profits as divided by the adjustment factor (i.e.  $\$10,000 \leq \$24,000 \div 2$ ).
- (2) The assessable profits from concessionary trading receipts shall be taxed at the concessionary tax rate, i.e. one-half of the normal tax rate.
- (3) The unabsorbed loss from normal trading receipts shall be deemed to be nil.

**Example 7 – Normal Loss exceeds Concessionary Profits / Factor, Section 19CA(3)(b) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Profit / (loss) <sup>(1)</sup>	(10,000)	<u>18,000</u>
Reduced by		
Concessionary profits divided by the adjustment factor (i.e. $\$18,000 \div 2$ )	<u>9,000</u>	<u>(18,000)</u>
Unabsorbed loss <sup>(2)</sup>	<u>(1,000)</u>	
Assessable profits <sup>(3)</sup>		<u>NIL</u>

- (1) Section 19CA(3)(b) applies as the amount of normal loss exceeds the amount of concessionary profits as divided by the adjustment factor (i.e.  $\$10,000 > \$18,000 \div 2$ ).
- (2) The unabsorbed loss from normal trading receipts shall be carried forward for set off under sections 19C and 19CB.
- (3) The assessable profits from concessionary trading receipts shall be deemed to be nil.

### ***Different business and different year of assessment – Section 19CB***

23. Section 19CB deals with the set off of profits or loss between partnerships and corporations and also loss brought forward from previous years of assessment. Section 19CB(2) applies when a taxpayer has concessionary loss to be set off against its normal profits whilst section 19CB(3) applies when a taxpayer has a normal loss to be set off against its concessionary profits. The essence of this provision with regard to the application of the adjustment factor is the same as that for section 19CA, as demonstrated by Examples 8 to 11 below:

#### **Example 8 – Normal Profits exceeds Concessionary Loss / Factor, Section 19CB(2)(a) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Loss brought forward <sup>(1)</sup>		<u>(10,000)</u>
Assessable profits <sup>(1)</sup>	8,000	
Reduced by		
Concessionary loss brought forward divided by the adjustment factor (i.e. \$10,000 ÷ 2)	<u>(5,000)</u>	<u>10,000</u>
Net assessable profits <sup>(2)</sup>	<u>3,000</u>	
Loss carried forward <sup>(3)</sup>		<u>NIL</u>

<sup>(1)</sup> Section 19CB(2)(a) applies as the amount of concessionary loss brought forward does not exceed the amount of normal profits as multiplied by the adjustment factor (i.e. \$10,000 ≤ \$8,000 x 2).

<sup>(2)</sup> The net assessable profits from normal trading receipts shall be taxed at the normal tax rate.

<sup>(3)</sup> The concessionary loss brought forward shall be deemed to have been fully set off.

**Example 9 – Normal Profits do not exceed Concessionary Loss / Factor, Section 19CB(2)(b) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Loss brought forward <sup>(1)</sup>		(10,000)
Assessable profits <sup>(1)</sup>	<u>4,000</u>	
Set off by		
Normal profits multiplied by		
the adjustment factor		
(i.e. \$4,000 x 2)	<u>(4,000)</u>	<u>8,000</u>
Loss carried forward <sup>(2)</sup>		<u>(2,000)</u>
Net assessable profits <sup>(3)</sup>	<u>NIL</u>	

<sup>(1)</sup> Section 19CB(2)(b) applies as the amount of concessionary loss brought forward exceeds the amount of normal profits as multiplied by the adjustment factor (i.e. \$10,000 > \$4,000 x 2).

<sup>(2)</sup> The concessionary loss after set off against normal profits shall be carried forward.

<sup>(3)</sup> The net assessable profits from normal trading receipts shall be deemed to be nil.

**Example 10 – Normal Loss does not exceed Concessionary Profits / Factor, Section 19CB(3)(a) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Loss brought forward <sup>(1)</sup>	<u>(10,000)</u>	
Assessable profits <sup>(1)</sup>		24,000
Reduced by		
Normal loss brought forward		
multiplied by		
the adjustment factor		
(i.e. \$10,000 x 2)	<u>10,000</u>	<u>(20,000)</u>
Net assessable profits <sup>(2)</sup>		<u>4,000</u>
Loss carried forward <sup>(3)</sup>	<u>NIL</u>	

<sup>(1)</sup> Section 19CB(3)(a) applies as the amount of normal loss brought forward does not exceed the amount of concessionary profits as divided by the adjustment factor (i.e. \$10,000 ≤ \$24,000 ÷ 2).

- (2) The net assessable profits from concessionary trading receipts shall be taxed at the concessionary tax rate, i.e. one-half of the normal tax rate.
- (3) The normal loss brought forward shall be deemed to have been fully set off.

**Example 11 – Normal Loss exceeds Concessionary Profits / Factor, Section 19CB(3)(b) scenario**

	<u>Normal trading receipts</u>	<u>Concessionary trading receipts</u>
	\$	\$
Loss brought forward <sup>(1)</sup>	(10,000)	
Assessable profits <sup>(1)</sup>		<u>18,000</u>
Set off by		
Concessionary profits divided by the adjustment factor (i.e. \$18,000 ÷ 2)	<u>9,000</u>	<u>(18,000)</u>
Loss carried forward <sup>(2)</sup>	<u>(1,000)</u>	
Net assessable profits <sup>(3)</sup>		<u>NIL</u>

- (1) Section 19CB(3)(b) applies as the amount of normal loss brought forward exceeds the amount of concessionary profits as divided by the adjustment factor (i.e. \$10,000 > \$18,000 ÷ 2).
- (2) The normal loss after set off against concessionary profits shall be carried forward.
- (3) The net assessable profits from concessionary trading receipts shall be deemed to be nil.

***Personal assessment is elected – Sections 19C(3A) and 42(1A)***

24. Where personal assessment is elected and the loss or share of loss in any year of assessment consists solely of the balance of concessionary loss calculated under section 19CA(2)(b), the amount of the loss or the share of loss to be transferred to personal assessment shall be deemed to be the amount arrived at by dividing such concessionary loss by the adjustment factor. For instance, if personal assessment is elected in Example 5 above, the amount of concessionary loss to be deducted from the total income of the personal assessment elector under section 42(2)(b) will be \$2,000 (i.e. \$4,000 ÷ 2).

## **RIGHTS OF OBJECTION AND APPEAL WHERE LOSSES ARE INCURRED**

25. An objection to the Commissioner (with the subsequent right of appeal to the Board of Review or the Court) only arises when a person is aggrieved by an assessment. A computation of loss does not state “the amount of tax charged, and such due date for payment thereof” as stipulated in section 62(1), per Yam J in *CIR v Yau Lai Man, Agnes trading as L. M. Yau & Company* 6 HKTC 485. This view was echoed by Deputy Judge To in *CIR v Common Empire Limited* 7 HKTC 52 where the learned judge at page 99 said:

“An ascertainment of loss which does not result in the application of the appropriate rate of tax to that loss is not an assessment within the meaning of the Ordinance.”

In the Court of Appeal, Rogers VP confirmed this construction as correct.

26. Accordingly, no right of objection arises unless and until such time as any loss claimed affects an assessment to tax. This right arises:

- (a) Where the assessor has not agreed a loss claimed to have been sustained in a year of assessment, and a notice of assessment has been issued resulting in a liability to profits tax or personal tax for that year;
- (b) Where the assessor has issued a notice of assessment with a liability to profits tax or personal tax for a year of assessment, which, in the opinion of the taxpayer, fails to set off of a loss sustained in the preceding year(s).

27. In the case of an unincorporated business (whether a sole proprietorship or a partnership), either the sole-proprietor or one or more of the partners may have elected for personal assessment. If the assessor disagrees with a loss claimed under profits tax but does not raise a profits tax assessment, no right of objection under profits tax arises at the time. However, the sole-proprietor, or any one of the partners who has elected for personal assessment, will be able to object against the personal assessment made on them if they are aggrieved by the assessment which does not allow the business loss to be set off, or allows a smaller amount of business loss than that claimed.

28. Where a corporation has an interest in a partnership, either the corporation itself or the partnership in which the corporation is a partner may sustain a loss in a year which can be set off in accordance with sections 19C(4) and (5). If the assessor disagrees with the loss claimed and the corporation or partnership, which is not allowed the benefit of the loss is aggrieved, a right of objection arises in the following situations:

- (a) The assessor computes the loss in an amount less than that claimed:
  - (i) Where the profits tax assessment is raised after the issue of the computation of loss, within one month after the date of issue of that assessment;
  - (ii) Where the profits tax assessment was raised before the issue of the computation of loss, within one month after the date of issue of the revised profits tax assessment.
- (b) The assessor does not agree that there is a loss and issues a “Nil” computation of loss:
  - (i) Where the computation of loss issues prior to the profits tax assessment, within one month after the date of issue of that assessment;
  - (ii) Where the computation of loss issues after the profits tax assessment, within one month after the date of issue of that computation.

The onus of lodging the notice of objection against such an assessment rests with the person on whom the profits tax assessment was raised.