IN THE COURT OF APPEAL OF THE DEMOCRATIC

SOCIALIST REPUBLIC OF SRI LANKA-11.12.2022

In the matter of a case stated under section 170 of the Inland Revenue Act, No. 10 of 2006 (as amended)

Indian Overseas Bank,
No. 139, Main Street,
P. O. Box 671,
Colombo 11.

Appellant

Case No. CA/TAX/0039/2014
Tax Appeals Commission
No. TAC/IT/033/2013

Vs.

The Commissioner General of Inland Revenue,
14th Floor, Department of Inland Revenue,
Sir Chittampalam A. Gardiner Mawatha,
Colombo 02.

Respondent

Before **:** Dr. Ruwan Fernando J. &

M. Sampath K.B. Wijeratne J.

: Riad Ameen with Rushantha Rodrigo for the Appellant

S. Balapatabendi, A.S.G. with Suranga Wimalasena, D.S.G. for the Respondent

Argued on : 28.03.2022 & 03.06.2022

Written Submissions filed on

: 25.10.2022 & 22.06.2018 (by the

Appellant)

04.10.2022 & 24.11.2018 (by the Respondent)

Decided on : 15.12. 2022

Dr. Ruwan Fernando, J.

Introduction

[1] This is an appeal by way of a case stated against the determination of the Tax Appeals Commission dated 01.10.2014 confirming the determination made by the Commissioner General of Inland Revenue on 10.04.2013 and dismissing the Appeal of the Appellant. The period relates to the year of assessment 2008/2009.

Factual Background

[2] The Appellant is a banking corporation duly incorporated in India and carrying on banking business in Sri Lanka through a branch office in Colombo. The Appellant is a licensed Commercial Bank in terms of the provisions of the Banking Act, No. 30 of 1998 (as amended). The principal activities of the Appellant include the provision of a comprehensive range of financial services, encompassing banking, corporate, personal, trade, finance, treasury and investment services (Vide-financial statement at p. 126 of the TAC brief).

[3] During the year of assessment 2008/2009, the Appellant (i) received a sum of Rs. 104,625,902/- as interest receipt from the foreign currency loan granted to the Government of Sri Lanka; (ii) received a sum of Rs. 2,168,222/- as interest income on Euro Deposits with other banks; (iii) received a sum of Rs. 74,218,923/- as interest income from the Government Development Bonds; and (iv) received an interest of Rs. 141,472,208/- on borrowing funds from the Central Office, overseas.

[4] The Appellant filed a Return of Income for the year of assessment 2008/2009 and claimed exemptions from the following interest income and expenses:

(a) Interest income of Rs. 104,625,902/- received in foreign currency from the said loan granted to the Government of Sri Lanka under section 9(b) of the Inland Revenue Act; No. 10 of 2006;

(b) Interest income of Rs. 2,168,222/- received on Euro deposits with other banks under section 9(d) of the Inland Revenue Act; No. 10 of 2006

(c) Interest income of Rs. 74,218,923/- on the Sri Lanka Development Bonds under section 9(f) of the Inland Revenue Act; No. 10 of 2006;

(d) Interest of Rs. 141,472,208/- on borrowing funds from the Central Office in India under the Double Taxation Avoidance Agreement (DTAA) between the Governments of India and Sri Lanka.

Assessor's decision on Interest income of Rs. Rs. 104,625,902/- received in foreign currency from the loan granted to the Government of Sri Lanka and interest income of Rs.2,168,222/- on Euro deposits

[5] The assessor by letter dated 22.03.2011 refused to grant the above-mentioned exemptions claimed by the Appellant under sections 9(b) and 9(d) of the Inland Revenue Act for the following reasons:

(a) The Appellant derived interest income from its business as a banker in the course of carrying on its business of banking and therefore, such income should be treated as business profits under section 3(a) of the Inland Revenue Act, No. 10 of 2006 (hereinafter referred to as the IRA 2006), which is liable to be taxed unless it is specifically excluded from the IRA 2006;

(b) As the profits or income of the Appellant expressly relates to the source of income under section 3(a) of the IRA 2006, the determination of any profits or income arising from any other source under section 3(e) would not apply under section 99 of the IRA 2006.

Assessor's decision on Interest income of Rs. 74,218,923/- on the Sri Lanka Development Bonds claimed by the Appellant under section 9(f) of the Inland Revenue Act

[6] The assessor by the same letter dated 22.03.2011 allowed the interest income of Rs. 74,218,923/- derived by the Appellant from monies invested in Sri Lankan Development Bonds under section 9(f) of the IRA 2006. The assessor however, disallowed the interest expense of Rs. 20,860,716/- being the expenses (referrable to Rs. 74,218,923/-) for the following reasons:

(a) The statutory income under section 28(1) should be the full amount of the profit or income which was derived by the Appellant or accrued to his benefit from such service during that year of assessment;

(b) Profit or income under section 217 means the net profits or income from any source for any period calculated in accordance with the provisions of the IRA 2006;

(c) The deductions under section 25(1) refer to all outgoings and expenses incurred by such person in the production of profits and income subject to the provisions of subsection (2) and (4) for the purpose of ascertaining the profits or income of any person from any source;

(d) Once a taxpayer is permitted a tax exemption with respect to a particular source of exempt income, he is not entitled to deduct the expenses incurred in producing such income;

(e) The Appellant failed to maintain and prepare statements of accounts in a manner that the profits and income from exempt income can be separately identified.

Assessor's decision on Interest of Rs. 141,472,208/- on borrowing funds from the Central Office, overseas

[7] The assessor disallowed the interest of Rs. 141,472,208 on borrowing funds from the Central Office, overseas on the ground that the auditors have noted that the borrowing from Central Office has not been confirmed.

[8] Accordingly, the notice of assessment was issued by the assessor, and being dissatisfied with the said assessment, the Appellant appealed to the Commissioner-General of Inland Revenue (hereinafter referred to as the Respondent).

Appeal to the Commissioner-General of Inland Revenue

[9] The Appellant appealed to the Commissioner-General of Inland Revenue (hereinafter referred to as the Respondent) against the said assessment. The Respondent by its determination permitted the interest of Rs. 141,472,208/- on borrowing funds from the Central Office, which the Appellant claimed, had been paid as interest to its Central Office in India, in relation to a loan granted to the Government of Sri Lanka. (Vide- reasons for the determination at pp. 1-5 of the Tax Appeals Commission brief). Accordingly, the Respondent determined that

the said sum paid as income tax is not liable to be taxed again in Sri Lanka, in terms of the Double Taxation Avoidance Agreement (DTAA) between the Governments of India and Sri Lanka.

Appeal to the Tax Appeals Commission & the Court of Appeal

[10] Being dissatisfied with the said determination of the Respondent, the Appellant appealed to the Tax Appeals Commission and the Tax Appeals Commission (hereinafter referred to as the TAC) held in its determination dated 01.10.2014 that the Appellant is not eligible for exemptions claimed and dismissed the appeal for the following reasons:

1. In terms of the decision in *Ceylon Financial Investment Ltd v. Commissioner of Income Tax*, 43 NLR 01, any special provisions applicable to interest and dividend should apply to dividends and interest, treated as profits of a business, subject to the qualification that section 9(3) of the Income Tax Ordinance, should be uniformly applied to all interest received (pp143-144);
2. The Appellant is carrying on banking business consisting of a range of comprehensive financial services and receiving interest income from foreign currency loan to the Government of Sri Lanka which fall within the meaning of section 3(a) of the IRA 2006 and therefore, the Appellant is not eligible for the exemptions claimed under the IRA 2006; (p 143);
3. Section 9(b) deals with exemptions from income tax of interest accruing to any company, and section 9(d) refers to any person dealing with a specialized activity of a bank, which has been given a special meaning in terms of section 2 of the Banking (Amendment) Act, No. 33 of 1995. If the legislature intended to grant special benefits to a specific bank such as the Appellant, and exempt interest claimed by such a specific bank, the legislature could have specifically stated so. in the IRA 2006 (pp. 141-142);
4. The exemption granted under section 9(d) is only applicable to the provision of section 3(e), and not trading income contemplated under section 3(a). In any event, section 9(d) is applicable to an individual as opposed to a banking business (p. 142 of the TAC brief);
5. The Appellant's source of income falls within the meaning of section 3(a) and not under section 3(e), which is a distinct source referred to in section 3 and therefore, in terms of section 99 of the IRA 2006, the Appellant is not

entitled to claim any benefit from the exemptions under section 9 of the ITA 2006 (pp. 141-143).

Appeal to the Court of Appeal & Questions of Law

[11] Being dissatisfied with the said determination of the TAC, the Appellant appealed to the Court of Appeal and formulated the following questions of law in the Case Stated for the opinion of the Court of Appeal.

1. Having acknowledged that the decision in the local case of *Ceylon Financial Investment Ltd v. Commissioner of Income Tax* –

   a. Binds both the parties as well as tribunals and courts; and

   b. Held that any special provision applicable to interest and dividend should apply to interest and dividends treated as profits of business.

   did the commission err in law in not allowing the exemptions claimed by the appellant in terms of Paragraph (b) and (d) of Section 9 of the Inland Revenue Act, No. 10 of 2006 (the Act) which are special provisions applicable to interests, in respect of interest received by it on the loan given to the government of Sri Lanka and on Euro deposits, respectively?

2. Did the Commission err in law when it erroneously assumed that Section 9 (d) refers to any person dealing in a specialized activity such as banking when Section 9 (d) does not have any words at all justifying the assumption of the commission?

3. Did the Commission err in law when it erroneously said that in any event section 9 (d) aforesaid is applicable to an individual as opposed to a banking business when the section itself does not refer to any individual at all but refers ANY PERSON?

4. Did the Commission err in law when the commission erroneously said that it was held in the case of *Ceylon Financial Investment Ltd v. Commissioner of Income Tax* that Section 9 (3) of the Income Tax Ordinance uniformly appealed to all interest received, whereas, the only judge, namely honorable Justice Soertz, who commented upon Section 9 (3) stated that he did not agree that Section 9 (3) uniformly applied to all interest received?

5. Having regard to the view held by the Supreme Court in the case of *Ceylon Financial Investment Ltd v. Commissioner of Income Tax* that the Section 47 of the Income Tax Ordinance which corresponds to Section 99 of the Act, supports the view of the court that-

    1. Interest continues to be a source of income falling within Section 6 (e) of the Income Tax Ordinance which corresponds to Section 3 (e) of the Act, notwithstanding that such interest is treated as profits of a trade falling within Section 6 (a) of the Income Tax Ordinance which corresponds to Section 3 (a) of the Act; and
    2. Any special provisions relating to interest and dividends apply to interest and dividends treated as forming part of the business profits of a company, did the commission err in law in the manner in which it appealed Section 99 of the Act to the interest received by the appellant?

6. Did the commission err in law when it totally failed to consider and determine the second issue in disputed in the case, namely, deductibility of interest expense of Rs. 20,860,766 referable to exempt interest of Rs. 74,218,923 which the appellant received on the money it invested in Sri Lanka Development Bonds?

7. Is not the appellant entitled to the exemption it claimed in terms of Section 9 (b) and Section 9 (d) of the Act respectively in respect of interest of Rs. 104,525,902 received on the loan granted to the government of Sri Lanka and interest of Rs. 2,168,222 received on Euro deposits?

8. Having regard to the provisions in the Article 7 of the Double Taxation Treaty between Sri Lanka and India is not the appellant entitled to deduct the entirety of the interest expense referred to earlier in the computation of its profits notwithstanding that the relevant interest income itself is exempt under the provisions of the Act?

9. Did the commission fail to properly examine and/or apply and/or appreciate the facts and the law relevant to this matter?

[12] At the hearing of the appeal, we heard Mr. Riad Ameen, the learned Counsel for the Appellant, and Mr. S. Balapatabendi, A.S.G. for the Respondent on the nine questions of law submitted for the opinion of the Court.

Matters to be determined

[13] The questions of law submitted for the opinion of this Court relate to the following four broad issues:

1. Whether on the facts and circumstances of the case, the interest income of Rs. 104,625,902/- in foreign currency derived from the loan granted to the Government of Sri Lanka should be exempted under section 9(b) of the Inland Revenue Act.

2. Whether on the facts and circumstances of the cases**,** the interest income of Rs. 2,168,222/- received on Euro deposit with other banks should be exempted under section 9(d) of the IRA;

3. Whether on the facts and circumstances of the cases**,** the deductibility of interest expense of Rs. 20,860,716/- in proportion to the sum invested in the Sri Lanka Development Bonds is erroneous.

4. Whether the Appellant is entitled to deduct the entirety of the interest expenses referred to in the computation of its profits, under Article 7 of the Double Taxation Treaty between the Government of India and Sri Lanka, notwithstanding that the relevant interest income is exempt under the provisions of the IRA 2006.

Analysis

Is interest received by the Appellant a source of income under section 3(a) or section 3(e) of the Inland Revenue Act?

[14] Now the question is to consider whether the interest income can be categorized as "profits and income" earned by the Appellant from business falling within the ambit of section 3 (a) of the IRA 2006, and if not, whether the interest income can also fall within the ambit of section 3(e) of the IRA 2006.

[15] Mr. Ameen submitted that the interest received by the Appellant should be treated as a source under section 3(e) of the IRA 2006, which specifically refers to interest whereas section 3(a) does not specifically refer to interest. He

submitted that although there is no specific reference to interest in section 3(a), it is possible for interest to be a source under section 3(a), if it can constitute a profit from business as observed by the judges in *Ceylon Financial Investments Limited V. Commissioner of Income Tax* (supra) (hereinafter referred to as the 'CFI judgment). He submitted however, that the judges in the CFI case concluded that the interest income is a source under section 6(1)(a) of the Income Tax Ordinance 1932 (correspond to section 3(a) of the IRA 2006), instead of section 6(1)(e) (correspond to section 3(e) of the IRA 2006).

[16] Mr. Ameen strongly relied on the five-bench decision of the Supreme Court in *Ceylon Financial Investments Limited V. Commissioner of Income Tax* (supra) in support of his contention that the interest received by the Appellant is a source under section 3(e), which can be clearly separated from the rest of its business, and therefore, the special provisions relating to interest under section 9 (b) and 9(d) of the IRA 2006 should apply to interest received by the Appellant. He submitted that contrary to the decision in *Ceylon Financial Investments Limited v. Commissioner of Income Tax* (supra), the TAC erroneously decided that the Appellant's interest income falls within the meaning of section 3(a), instead of section 3(e) of the IRA 2006 and therefore, section 9 of the IRA 2006 has no application in terms of the provisions of section 99 of the IRA 2006.

[17] It is not in dispute that section 6(1)(a) of the Income Tax Ordinance 1932 is corresponding to section 3(a) of the IRA 2006 and section 6(1)(e) of the Income Tax Ordinance 1932 is corresponding to section 3(e) of the IRA 2006. Mr. Balapatabendi, however, disputed the submission of Mr. Ameen that the source of profit or income could fall within two separate subsections in section 3, and that the judgment in CFI is no authority for the assertion of the Appellant that the source of profits or income could fall within two separate subsections of section 3. He further submitted that section 47 of the Income Tax Ordinance (current section 99 of the IRA 2006), that was in force at the time of the judgment, would have statutorily precluded the Supreme Court from making a pronouncement that a source of profit/income could fall within two separate subsections of section 6 (1) of the Income Tax Ordinance 1932

[18] At the hearing, we had the benefit of a full and able arguments from Mr. Ameen and Mr. Balapatabendi, who made extensive submissions with regard to the applicability of the judgment in CFI case to the determination of the profits or income of the Appellant, either under section 3(a) or 3(e) of the IRA 2006. The Respondent also relied on the judgment of CFI in deciding whether the profits

or income of the Appellant falls under section 3(a) or 3(e) of the IRA (pp.25-26, 167 of the TAC brief) It is therefore, necessary to identify the ratio of the said judgment and decide whether the interest can be a source under section 3(a) or 3(e) of the IRA 2006, and if so, in what circumstances will interest can be a source under section 3(a) or 3(e) of the IRA 2006.

Characterization of profits and income earned by the Appellant under section 3 (a) or 3 (e) of the IRA 2006.

[19] For the purpose of the determination of the Questions of Law, it is necessary, first, to decide whether the interest income received by the Appellant is a source of income under section 3(a) or 3(e) of the IRA 2006. Before I embark upon the rival contentions of the parties, I may proceed to consider the relevant statutory provisions which have a bearing on the issue before this Court. Section 2 of the IRA 2006 provides that "*income tax shall, subject to the provisions of this Act, be charged at the appropriate rates specified in the First, Second, Third, Fourth and Fifth Schedules to this Act, …in respect of the profits and income of every person for the year of assessment*….".

[20] Section 3 of the IRA 2006 specifies different sources of income and profits which are chargeable with income tax. Section 3(a) of the IRA 2006 provides as follows:

"For the purpose of this Act, "profits and income" or "profits" or "income" means-

(a) the profits from any trade, business, profession, or vocation for however short a period carried on or exercised".

[21] On the other hand, section 3 (e) of the IRA 2006 refers to income received from dividends, interest or discounts. It provides:

(e) "dividends, interest or discounts".

[22] It may be noted that the classification of the source of income is significant as different rates apply to different sources of income specified in the five Schedules to the IRA 2006. In the circumstance, it is necessary for the assessor to ascertain and identify the source of income for the purposes of determining the profits and income chargeable with income tax, and the rates applicable to such source of income. The list of heads in section 3 is the list of sources is one source such as "profits from one business" in section 3(a) is distinct from

"employment" in section 3(b), or business in section 3(a) is distinct from "dividends, interest or discounts" as a source. One of the heads (sources) is the "profits from any trade, business, profession or vocation for however short a period carried on or exercised" under section 3(a), and the other is "dividends, interest or discounts" under section 3(e) of the IRA 2006.

Judgment of the Supreme Court in *Ceylon Financial Investments Limited V. Commissioner of Income Tax* (CFI Case)

[23] I will now turn to the CFI judgment. The facts of the CFI judgment reveal that the assessee company was an investment company and its object was to invest money in shares in other companies. Its income was derived from dividends declared by companies in which it owned shares, and interest on moneys lent out by it. The company did not carry on any trade and claimed deductions from outgoings and expenses in the production of the profits or income within the meaning of section 9(1) of the Income Tax Ordinance (Chapter 188) (corresponding to section 25(1) of the IRA 2006).

[24] Unlike in the present case, the assessee argued in the CFI case that the interest income should be treated as a source under section 6(1)(a) of the Income Tax Ordinance 1932 (corresponding to section 3(a) of the IRA 2006), and the assessor in disallowing the management expenses claimed drew a distinction between an investment company and a company which carried on a trade or commercial enterprise. The assessor stated however, that (i) an investment company does not incur any expense in the production of income, and once the investment was made, no further expenditure was necessary for the production of its income from the investment; and (ii) section 10(b) also precluded any such deduction as claimed. The assessor treated the interest income under section 6(1)(e) of the Income Tax Ordinance 1932 (correspond to section 3(e) of the IRA 2006) and disallowed the deduction of management expenses in producing its interest income in terms of section 9(3) of the Income Tax Ordinance 1932 (corresponding to section 25 (4) of the IRA 2006). The Commissioner also disallowed the management expenses claimed as deductions from the income of the company and the Board of Review confirmed the determination of the Commissioner.

[25] It is relevant to note that there was no dispute in the CFI case that the appellant company though functioning as an investment company only, and that the investment was the purpose for which it was formed, it still continued to

carry on business in the way of a holding company. The issue in CFI case was whether the management expenses (such as Directors', Secretaries' and Auditors' fees) could be deducted from its income derived from dividends and interest in ascertaining the assessable income of the company under section 9(1) of the Income Tax Ordinance 1932 (corresponding to section 25(1) of the IRA 2006). The CFI judgment dealt with the following two issues:

1. whether the income derived from dividends and interest was a source under section 6(1)(a) or section 6(1)(e) of the Income Tax Ordinance, 1932;
2. Even if the appellant company was carrying on a business and for that reason, came under section 6(1)(a), was entitled to deduct the management expenses derived from dividends and interest in ascertaining the net profits and income, whether under section 9(1) or 9(3) of the Income Tax Ordinance;
3. Even if the appellant company was carrying on a business and for that reason, came under section 6(1)(a), and the gain derived from dividends and interest falls within the words "dividends, interest or discounts" of section 6(1)(e), whether the Income Tax officer was entitled to elect under which heads 6(1)(a) or 6(1)(e), it will make its assessment.

Whether, in terms of the CFI judgment, the income derived from dividends, interest or discounts falls within the words "profits from any business" under section 6(1)(a) or within the terms "dividends, interest or discounts" under section 6(1)(e) of the Income Tax Ordinance, 1932,

[26] The first question that was considered by the judges in the CFI case was whether the income derived by the company from dividends and interest was a source under section 6(1)(a) or section 6(1)(e) of the Income Tax Ordinance, 1932, which corresponds to section 3(a) and 3(e) of the IRA, No. 10 of 2006 respectively.

[27] The argument of the Appellant in that case was that income should have been assessed under section 6(1)(a) of the Ordinance as a business and therefore, such expenses should have been allowed under section 9(1) (current section 25(1) of the IRA 2006) as "all outgoings and expenses incurred by such person in the production thereof". The Crown argued that the profits or income of the assessee came exclusively under section 6(1)(e) (current section 3(e) of the IRA) and could not be regarded as the profits and income of a business. Alternatively, the Crown argued that if the profits and income came both under

section 6(1)(a) and under section 6(1)(e), the Crown had an option as to the sub-section under which the tax could be charged.

[28] It may be noted that section 9(1) of the Income Tax Ordinance, which relates to the deductions allowed in ascertaining profits or income, is identical to section 25(1) of the IRA. It reads as follows:

> *"(1) Subject to the provisions of subsections (2), and (3), there shall be deducted, for the purpose of ascertaining the profits of income of any person from any source, all outgoings and expenses incurred by such person in the production thereof…."-*

[29] Section 9(3) of the Income Tax Ordinance is identical to section 25(4) of the IRA 2006 and it reads as follows:

> *"(3) Subject as hereinafter provided, Income arising from interest shall be the full amount of interest falling due, whether paid or not, without any deduction for outgoings or expenses:"*

[30] Section 10) (b) of the Income Tax Ordinance reads as follows:

> *"For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of ……,*
>
> *(b) any disbursements or expenses not being money expended for the purpose of producing the income".*

[31] In the light of those facts and the arguments advanced on behalf of the assessee and the assessor, the Supreme Court proceeded to consider first, whether the source of profits and income of the assessee in that case fell within the meaning of section 6(1)(a) or section 6(1)(e) of the Income Tax Ordinance. The judges in the CFI case then proceeded to lay down tests for determining whether interest was a source of income under section 6(1)(a) or 6 (1)(e) of the Income Tax Ordinance. Howard C.J., Keuneman J. and Soertsz J. delivered separate judgments, and De Kretser, J. did not deliver a separate judgment, but agreed with the judgment of Soertsz, J. Wijewardene, J. delivered a brief judgment, but agreed with the reasoning of Keuneman J.

[32] It is relevant to note that in the CFI judgment, both Howard C.J., and Keuneman J. recognized that the income derived from dividends and interest falls within the words "profits from business" under section 6(1)(a), or within the terms "dividends, interest or discounts" under section 6(1)(e) of the Income Tax Ordinance (pp. 7, 8, & 19). Howard, C.J. then proceeded to consider in what circumstances will interest be a source under section 6(1)(a) or under section

6(1)(e). In order to determine this question, Howard C.J. laid down the following test at page 250 of the judgment:

> "*If the business of a company consists in the receipt of dividends, interest or discounts alone or if such a business can be clearly separated from the rest of the trade or business, then any special provisions applicable to dividends, interest or discounts must be applied. Applying the principle laid down in the Egyptian case, the appellant company is within source (e) and cannot get out of it. To take such a view does not in any way disturb the scheme of the Ordinance. I agree, therefore, with Keuneman J. that the Commissioner was empowered to charge the appellant Company under section 6 (1) (e) in respect of the dividends and interest received from undertakings in which its capital was invested"* (Emphasis added).

[33] Howard C.J. held that the company is within source (e) and cannot get out of it and therefore, the Commissioner was empowered to charge the company under section 6(1)(e) in respect of dividends and interest received from undertakings in which its capital was invested (p 11). Howard C.J. then proceeded to consider whether the management expenses are deductible under section 9(1) as outgoings and expenses incurred "in the production of the profits". Howard C.J. held that as section 9(1) employs the word "any source", it must be regarded as having reference to section 6(1). Accordingly, Howard C.J. opined that "the management expenses of the appellant company are deductible as incurred in the production of the profits" (p. 7.

[34] Keuneman J., while disagreeing with Howard, C.J. on the option available to the Income Tax Commissioner, however, agreed with the test adopted by Howard C.J. Keuneman J. first proceeded to consider in what circumstances will interest be a source under section 6(1)(a) or under section 6(1)(e). Keuneman J., laid down the following test at pp. 261-262 of the judgment:

> *'How then are we to treat income which comes under source (e) but can also be regarded as coming under source (a)? In my opinion, it was the intention of the Ordinance to regard dividends, interest or discounts as a separate source. If then the business of an individual or a company consists in the receipt of dividends, interest or discounts alone, or if the business of receiving dividends, interest or discounts can be clearly separated from the rest of the trade or business, then any special provisions applicable to dividends, interest or discounts must be applied. I do not think any question of opinion arises.* (Emphasis Added).

Option of the Income Tax Officer to elect the source of income under section 6(1)(a) or 6(1)(e)

[35] In the question whether the Crown had an option to elect the source of income, the majority of the Judges, comprising Keuneman J., Soertsz J. and Kretser J. held that the Crown had no option to elect whether it will assess under section 6(1)(a) or 6(1)(e). Keuneman, J. specifically stated at p. 20 that section 47 of the Income Tax Ordinance, which correspond to section 99 of the IRA 2006 lends support to this view.

Deduction of Management Expenses

[36] The next question in the CFI case was whether management expenses were incurred in the production of profits and deductible under section 9(1) of the Income Tax Ordinance. The deductions claimed by the Appellant in the CFI case were "outgoings and expenses incurred in the production" of the profits or income within the meaning of section 9(1) of the Income Tax Ordinance. The Crown argued that the management expenses were not incurred in the production of profits and income. It was not in dispute that though the appellant company in the CFI case was formed as an investment company, it carried on business in the way of a holding company and that everything that accrued to the company, in the course of its business, by way of pecuniary gain, whether by way of dividends, interest, discounts or some other thing falls within the words "profits from any business".

Expenses incurred in earning dividends

[37] Both Howard C. J, and Keuneman J. turned to the management expenses incurred in relation to dividends, arising from the production of income and held that they are necessary and reasonable expenses (p. 22). Howard C.J. and Keuneman J. recognized that section 9(1) which relates to ascertaining of profits and income of any person applies to "all the sources" of income set out in section 6(1), but places interest on a different footing under section 6(1)(e), if such interest can be separated from the rest of the trade or business.

[38] Howard C.J. having regard to the facts of the case, held that the income derived by the Appellant from dividends and interest falls within the meaning of section 6(1)(e) of the Income Tax Ordinance, and the management expenses can be deducted as outgoings and expenses incurred in the production of income and profits under section 9(1). Howard C.J. agreed with Keuneman J. that the Commissioner was empowered to charge the company under section

6(1)(e) in respect of dividends and interest received in the production of profits and income under section 9(1) of the Income Tax Ordinance.

[39] As far the deduction of management expenses in relation to dividends, which the company obtained was concerned, Keuneman J. rejected the submission of the Crown that the company has not done anything to produce the income or profits under section 9(1). Keuneman J., held that section 9(1) "would therefore *prima facie* apply to all the sources in section 6(1)(a) to (h)" (p. 21). Keuneman J., further rejected the argument of the Crown that nothing has been done by the company to produce the income or profits, and held that "the management expenses" claimed in the case have been incurred in the production of the income. Keuneman J., further held that management expenses incurring in the production of income can be deducted from any source, including from source 6(1)(e) and agreed with Keuneman J. that management expenses incurred by the company could be deducted under section 9(1) of the Income Tax ordinance.

[40] Keuneman J. decided that the management expenses can be deducted as far as they relate to the dividends which the company obtained in producing the profits or income under section 9(1) of the Income Tax Ordinance 1932.

Expenses incurred in the production of interest-special considerations

[41] It was the opinion of Keuneman J. that though the interest can be a separate source under section 6(1)(e), that source is subject to *"all outgoings and expenses incurred ……in the production of the profits or income*", and thus, they must be deducted. Keuneman J. then turned to the deduction of interest income earned by the company and referred to section 9(1) and 9(3) of the Income Tax Ordinance. Section 9(1) refers to the deductions for the purpose of ascertaining the profits or income from any source, all outgoings and expenses incurred by any person in the production thereof and section 9(3) refers to income arising from separate interest, whether paid or not, without any deduction for outgoings or expenses.

[42] Keuneman J. held that had the earning of interest been the **sole and separate business of the company**, the **special provision in section 9(3)** (correspond to section 25(4) of the IRA 2006) would apply. Keuneman J. however, refused to apply the special provision in section 9(3) on the basis that the company carried **on one business**, **which has two branches**, viz. the earning of dividends and earning of interest, but the interest is only a

subsidiary part of the business, which is not separated from its ordinary financial business. Accordingly, Keuneman J., refused to apply the special provision in section 9(3), which corresponds to section 25(4) of the IRA 2006. But His Lordship applied the general rule of deduction under section 9(1), which corresponds to section 25(1) of the IRA 2006. The findings of Keuneman J. at p. 22 of the judgment read as follows:

> *"What is the position, as regards the items of interest earned by the company? Had the earning of interest been the sole or separate business of the company, no doubt the special considerations under section 9(3) would have been applicable. But it is clear in this case that the company carries on one business, which has two branches, viz., the earning of dividends and the earning of interest and it is clear on the figures available to us (see Document X) that interest is only a subsidiary part of the business, and is not separated from its ordinary financial business. The interest is "embedded" in the business (in the words of Rowlatt J.) or "a mere incident" in the business (in the words of Lord Hanworth M.R.)-see Butler v. The Mortgage Company of Egypt, Ltd. I do not think it can be separated off or identified as distinct from the general business of the company. I do not* ***think therefore that these items are assessable as such. The ordinary rule under section 9(1) therefore applies and the deductions claimed can be allowed in their entirety*** *[emphasis added].*

[43] On the question whether or not the deductions mentioned in the general rule under section 9(1) (corresponding to section 25(1) of the IRA) applies to all "sources" of income under section 6(1), Keuneman J. held that the deductions mentioned in section 9(1) apply to all "sources of profit and income" in the following words (p. 23):

> *"I only repeat that the deductions mentioned in section 9 apply to all "sources" of profit and income".*

[44] It is relevant to note that Keuneman J. took the view that section 9(3) applies where the interest is a separate source which is not embedded in the in its general activities in producing its aggregate income and refused to apply section 9(3) as the income was embedded in the business in producing its aggregate income.

[45] Having considered the word "any source" which is employed in section 9(1), which refers to either 6(1)(a) or 6(1)(e), Keuneman J. deducted the management expenses in relation to interest earned by the company under the general rule in section 9(1) (corresponding to section 25(1) of the IRA) and not under the special rule in section 9(3). On that basis, the deduction of management

expenses claimed arising from interest was allowed as outgoings and expenses incurred in the production of the income under section 9(1), which corresponds to section 25(1) of the IRA 2006.

[46] Applying the said principles of law, Keuneman J. finally allowed the appeal and deducted the management expenses incurred in the production of income in relation to dividends and interest in ascertaining the assessable income of the company under section 9(1) (corresponding to section 25(1) of the IRA).

[47] The combined effect of the test applied by Howard CJ., and Keuneman J. (with Wijewardene, J. agreed) was that "if the business of a company or individual consists in the receipts of dividends, interests or discounts alone, or if such business can be clearly separated from the rest of the trade, business, then section 3(1)(e) will apply. In other words, if the business of a company or an individual consists in the receipts of dividends, interest or discounts and such business cannot be separated from the rest of the trade or business, and the interest is embedded in the business, such interest or dividends or discounts falls within the meaning of section 3(1(a) of the Act.

[48] The test adopted by Howard C.J., and Keuneman J. applies to identify in what circumstances will dividends, interest or discounts be a source under section 6(1)(a) or under section 6(1)(e). That test has no application to the deductions of expenses mentioned in section 9(1) or 9(3), which relate statutory exemptions. Accordingly, the CFI judgment ultimately determined the deduction of expenses derived from dividends and income separately by the application of the general rule under section 9(1) and the special deduction rule under section 9(3). Both Howard C.J., and Keuneman J. confirmed that though the source of income falls under section 6(1)(e), which stands on a different footing in section 6(1), section 9(1) applies to all sources, whether under 6(1)(a) or 6(1)(e) and thus, to all outgoings and expenses incurred in the production thereof. Accordingly, the management expenses incurred in the production of income or profits earned from dividends and interest were held to be deductible under the general rule in section 9(1).

[49] It is relevant to note however, that Soertsz J. (with whom de Kretser J., agreed) disagreed with Keuneman J. that it was the intention of the Ordinance to regard dividends, interest or discounts as a separate source (p. 252). Soertsz J. held that the question whether it was profits from dividends or interests or discounts falls within section 6(1) or 6(1)(e), and depends on whether or not the

assessor deals with the profits of a "business" or the **income of an "individual**". Soertsz J. held that where it is appertaining to an income of a business, it falls within 3(1)(a), and where it is related to an income of an individual, as part of his business, it falls within section 6(1)(e). The relevant passage of the judgment at p. 252 reads as follows:

> "*The view I have reached is that the categories enumerated in section 6 (1) are mutually exclusive, and that the question whether 6 (1) (a) or 6 (1) (e) applies in a particular case, depends on whether we are dealing with the profits of a business or the income of an individual. If it is a case of dividends, interests, or discounts appertaining to a business, they fall within the words "profits of any business" and section (6) (1)(a) applies. If, however, it is a case of dividends, interest or discounts accruing to an individual not, in the course of a business, but as a part of his income from simple investments, then section 6 (1) (e) is the relevant section, and so far as interest is concerned, section 9 (3) modifies section 9 (1)*" (Emphasis added).

[50] The above passage of the judgment of Soertsz J. suggests that the following test would apply to identify whether the profits and income of an individual or business fall within section 3(1)(a) or 3(1) (e):

1. If the profits or income received from dividends or interest or discounts appertains to the business, it will fall within the profits of any business under section 6(1)(a);
2. If the profits or income received from dividends or interest or discounts accruing to an individual was earned, not in the course of a business, but as a part of his income from simple investments, it falls within section 3(1)(e).

[51] The test applied by Soertsz J. that section 6(1)(e) is limited to an income of an "individual" and section 6(1)(a) is limited to the profits of any "business" is not, in my view consistent with the scheme of the IRA 2006, which does not restrict the application of section 3(1)(e) to an individual. In my view, the tests laid down by Howard CJ., and Keuneman J., are significant to identify the source of profits or income under which chargeability arises and to decide in what circumstances, will the dividends, interest or discounts be a source under section 3(a) or 3(e). The identification of the source of profits or income is also significant to apply the general rule of deduction under section 25(1) or special rules of deduction under section 25(1)(a)-(w) of the IRA 2006 to particular sources or profits or income, irrespective of whether the source falls under section 3(a) or 3(e) of the IRA 2006.

[52] Applying the above principles adopted in the majority decision of the CFI judgment, we will now proceed to consider whether the interest income earned by the Appellant falls within the words "profits from any business" under section 3(a) or under the term "interest" under section 3(e) of the IRA 2006.

Double Taxation Avoidance Agreement (DTAA) between India and Sri Lanka

[53] Before, we proceed to classify the source of income of the Appellant under section 3(a) or 3(e), it is relevant to consider the effect of the Double Taxation Avoidance Agreement (hereinafter referred to as the "DTAA"). DTAA) between India and Sri Lanka. The DTAA applies to taxes on income and capital imposed on behalf of each Contracting State irrespective of the manner in which they are levied (Article 2.2). The existing taxes to which this Convention shall apply in Sri Lanka are (i) the income-tax, including the income-tax based on the turnover of enterprises licensed by the Greater Colombo Economic Commission; and (ii) the wealth-tax (Article 2.3).

[54] The DTAA is a contract between two Sovereign Governments of India and Sri Lanka, and the contract has been signed by the two sovereign governments with full knowledge, understanding and free consent of both governments. Relief by way of an exemption shall be considered in case of a DTAA in terms of Section 97 of the Inland Revenue Act, No. 10 of 2006. Section 97 reads as follows:

"97 (1) (a) Where Parliament by resolution approves any agreement entered into between the Government of Sri Lanka and the Government of any other territory or any agreement by the Government of Sri Lanka with the Governments of any other territories, for the purpose of affording relief from double taxation in relation to income tax under Sri Lanka law and any taxes of a similar character imposed by the laws of that territory, the agreement shall, notwithstanding anything in any other written law, have the force of law in Sri Lanka, in so far as it provides for–

(i) relief from income tax;
(ii) determining the profits or income to be attributed in Sri Lanka to persons not resident in Sri Lanka, or determining the profits or income to be attributed to such persons and their agencies, branches or establishments in Sri Lanka;
(iii) determining the profits or income to be attributed to persons resident in Sri Lanka who have special relationships with persons not so resident
(iv) exchange of information; or
(v) assistance in the recovery of tax payable.

[55] There are two situations under which the relief can be achieved in Sri Lanka under the DTAA between India and Sri Lanka:

(a) Where income tax has been paid under the IRA 2006 of Sri Lanka and the corresponding Indian Income Act or income tax remains taxable in both countries (whether at a full or reduced rate), as the country of residence, Sri Lanka will give a tax credit for the purpose of Sri Lankan taxation; or

(b) Where exemption from taxation exists, Sri Lanka may grant the exemption from income tax in respect of the agreed source of income under the DTAA subject to conditions laid down in the domestic law or the DTAA.

[56] As per the IRA 2006 (s. 97), where the government has entered into a DTAA, then in relation to the assessee to whom such Agreement applies, the provisions of the DTAA, with respect to cases to which they would apply, would operate even if inconsistent with the provisions of the IRA 2006. As a consequence, if a tax liability is imposed by the provisions of the IRA, the DTAA may be referred to and relief may be granted either by deducting or reducing the tax liability, and the Treaty provisions would prevail, and are liable to be enforced in Sri Lanka and India.

[57] It is not in dispute that the Appellant is a non-resident banking institution operating through a branch in Sri Lanka and thus, it has a permanent establishment (PE) in Sri Lanka within the meaning of Article 25 of the DTAA between India and Sri Lanka The Appellant who is carrying on business in Sri Lanka through a permanent establishment (PE) is therefore, subject to the Sri Lankan tax laws in respect of profits attributable to its permanent establishment (PE) in Sri Lanka subject to the stipulations of relevant laws in Sri Lanka.

Business activities of the Appellant & the profits and income claimed by the Appellant

[58] It is relevant to note that the issue in the CFI judgment related to the deduction of management expenses incurred in the production of dividends and interest under section 9(1) of the Income Tax Ordinance 1932. In the present, the issues relate to the exemption of income derived from loans, investment of moneys in the government securities and euro deposits in banks under section 9(b) and 9(d). The issue also relates to the interest expenses incurred in relation to Government Development Bonds under section 9(f) of the IRA 2006.

[59] In determining whether the interest income falls under section 3(a) or 3(e) of the IRA 2006, it is necessary to identify the business activities of the Appellant and the profits and income claimed by the Appellant under a particular source of income. As noted, section 3 enumerates the sources and categories of profits and income that are subject to tax and therefore, it includes any "profits and income" or "profits" or "income" from any source listed in paragraphs (a)-(j) of section 3 of the IRA 2006. The definition in section 217 provides that "profits" or "income" means the net profits or income from "any source" for any period calculated in accordance with the provisions of the Act. The term "income" is not however, defined.

[60] In *Thornhill v. The Commissioner of Income Tax* (supra), the main question was whether the sum of Rs. 19,622.19 was received by the Appellant in respect of his estate under the Tea and Rubber Control Ordinance as tea and rubber coupons to which he was entitled under the said Ordinance, and realised by the sale of these coupons constituted profit or income within the meaning of Section 6 (1) (a) or 6 (1) (b), or whether it represented realisation of capital.

[61] Soertsz J. in that case referred to the statement made in *Tennant v. Smith* (1892) A.C. 150 that "for income tax purposes, 'income' "must be money or something capable of being turned into money". But, Soertsz J. held however, that this statement needs qualification as all moneys and all things capable of being turned into money are not necessarily "income" for tax purposes. Soertsz J. referred to the following essential characteristics of "income" identified by Cunningham and Dowland in their Treatise on "Land and Income Tax and Practice", at p. 128, and held that these essential elements provide adequate tests by which to ascertain whether a particular receipt is "income" or not within the meaning of the Income Tax Ordinance. They are:

(a) It must be a gain;

(b) It must actually come in, severed from capital, in cash or its equipment;

(c) It must be either the produce of property or/and the reward of labour or effort;

(d) It must not be a mere change in the form of, or accretion to, the value of articles in which it is not the business of the taxpayer to deal; and

(e) It must not be a sum returned as a reduction of a private expense.

[62] Having applied the above-mentioned tests, Soertsz J. held *inter alia,* that (i) the amount in question is "profits and income" derived from the business of an agricultural undertaking carried on by the appellant, and is therefore assessable under section 6 (1) (a); (ii) if it does not fall within the scope of section 6 (1) (a), it is caught up by the "residuary" subsection 6 (1) (h) as this is not something casual or something in the nature of a windfall.

Meaning of "carried on or exercised" in section 3(a)

[63] Now, it is necessary to determine whether or not the Appellant carried on a business and earned profits from such business within the meaning of section 3(a), or merely received an income on a different footing, which can be separated from its business income within the meaning of section 3(e) of the IRA 2006. It is relevant to note that "the profits from any trade, business, profession or vacation for however short period." in section 3(a) is subject to a qualifying phrase "**carried on or exercised".** The word "business" has been defined in Section 217 of the Inland Revenue Act of 2006. It reads as follows:

> *"Business" **includes** an agricultural undertaking, the racing of horses, the letting or leasing of any premises, **including** any land by **a company and the forestry**".*

[64] The definition of "business" in Section 217 is inclusive and not exhaustive in nature and thus, it includes an agricultural undertaking, the racing of horses, the letting or leasing of any premises, including any land by a company and the forestry. Jessel M.R. in *Smith v. Anderson* [1880] 15 Ch D 247 (CA) stated that (i) the word " business " is a word of large and indefinite import and it is something which occupies attention and labour of a person for the purpose of profit; and (iii) the word means almost anything which is an occupation or duty requiring attention as distinguished from sports or pleasure; (iii) it is used in the sense of occupation continuously carried on for the purpose of profit. He explained the word "business" at pp. 258-259 as follows:

> *"Now "business" itself is a word of large and indefinite import. I have before me the last edition of* Johnson's Dictionary, *edited by Dr.* Latham, *and there the first meaning given of it is, "Employment, transaction of affairs"; the second, "an affair"; the third, "subject of business, affair, or object which engages the care." Then there are some other meanings, and the sixth is, "something to be transacted." The seventh is, "something required to be done." Then taking the last edition of the* Imperial Dictionary, *which is a very good dictionary, we find it a little more definite, but with a remark which is worth*

reading: "Business, employment; that which occupies the time and attention and labour of men for the purpose of profit or improvement." That is to say, anything which occupies the time and attention and labour of a man for the purpose of profit is business. It is a word of extensive use and indefinite signification. Then, "Business is a particular occupation, as agriculture, trade, mechanics, art, or profession, and when used in connection with particular employments it admits of the plural that is, businesses."

[65] The words "carrying on or exercised" are not defined in the Act. Section 3(a) however, includes every trade, business, profession or vacation however short a period. The question whether a person is or is not carrying on business is an inference from facts and the circumstances each case. As a general rule, one of two isolated transactions could not be described as the carrying on of a business subject however, to certain exceptions (Sikke on South African Income Tax, 3rd Ed. 1965, p. 478). For example, a single transaction is of such a nature that it could be correctly described as a business (supra).

[66] In considering whether a taxpayer is carrying on business, the frequency, systematically and regularity of the action or the earning of the income involves the conduct of a series of action that give rise to the carrying on a business (Sikke on South African Income Tax, 3rd Ed. 1965, p. 478). On the other hand, the investment of surplus funds in shares in companies, as long as it forms part of a general scheme of profit-making, can be regarded as carrying on business (supra).

[67] It is settled law that the terms "carrying on or carrying out "appears to cover the habitual pursuit of a course of conduct for the purpose of earning profits with proof of continuity. The following statement made by Brett, L.J. in *Erichsen v. Last* (1881) 4 TC 422, at p. 425 is significant to ascertain whether a business is exercised or carried on or transacted in a country:

"Now, I should say that whatever profitable contracts are habitually made in England, by or for a foreigner with persons in England because these persons are in England, to do something to those persons and, such foreigners are exercising are exercising a profitable trade in England, even although everything done by or supplied by them in order to fulfil their part of the contract is done abroad".

[68] The Appellant has been assessed by the assessor on the basis that the interest income earned by the Appellant from its banking business is a source that falls within the terms "trade, business …for however short a period carried on or exercised" in section 3(a) of the IRA 2006. The Appellant concedes that the

interest received by a bank can fall to be treated as "profits of a business" falling within section 3(a) of the IRA 2006 as well as section 3(e) of the IRA 2006 (p. 74 of the TAC brief). The Appellant's stand is however, that the special provisions relating to interest under section 9 applies even if the interest comes within section 3(a) of the IRA on the basis of the judgment in CFI case (vide p. 74 of the TAC brief).

[69] The Appellant is a non-resident banking institution carrying on banking business in terms of the provisions of the Banking Act, No. 30 of 1988 (as amended). Section 86 of the Banking (Amendment) Act, No. 30 of 1988 defines a banking business as follows:

> *"Banking business means the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part for advances, investments or any other operation either authorized by law or by customary banking practices"*.

[70] Section 6 of the Banking Act, No. 30 of 1988 (as amended) provides that no commercial bank shall carry on any banking business other than business specified in the licence. It reads as follows:

> *"6(1) Subject to the provisions of section 17, no licensed commercial bank shall:*
>
> *(a) carry on any banking business other than the business specified in the license; or*
> *(b) carry on any other business other than those specified in Schedule 11 to this Act"*.

[71] At the hearing on 28.11.2022, Mr. Ameen stated that the interest is the core business of the Appellant, but the interest income can be separated from its other business activities and therefore, the Appellant's interest income falls under section 3(e). Mr. Balapatabendi, however, submitted that the Appellant's interest income is associated with its banking business and therefore, it cannot be separated from its other branches.

[72] It is not in dispute that the Appellant is a licensed commercial bank to which a licence has been issued under the provisions of the Banking Act, No. 30 of 1988 (as amended) for carrying on banking business as defined in section 86 of the said Act. In terms of item 17 of Schedule 1 of the said Act, the Appellant Bank is listed as a licensed commercial bank under section 2(3) of the said Act. In terms

of the definition of banking business, the Appellant bank is entitled to engage in the following business activities *inter alia*:

1. receiving deposits from the public and paying money upon demand;
2. issuing fixed deposits;
3. providing loans and advances with interest;
4. accepting, discounting, buying, selling, collecting and dealing in bills of exchange;
5. the purchasing and selling of bonds, scripts or other forms of securities on behalf of constituents or others;
6. investments in treasury bonds;
7. investment in development bonds issued by the Central Bank of Sri Lanka;
8. other financial services.

[73] According to the financial statement of the Appellant, the Appellant provides a comprehensive range of financial services encompassing corporate, personal, trade, finance, treasury and investment services (p. 38 of the TAC brief). The Appellant's argument is that (i) the interest earned by the Appellant in granting loans to the Government of Sri Lanka, investment in Government Development Bonds and with other banks is a source under section 3(e); (ii) interest receipts of the Appellant can be separated from the rest of the business and therefore, interest is a source under section 3(e); and (iii) accordingly, the special provisions relating to interest under section 9 should apply to interest earned by the Appellant.

[74] According to the financial statement of the Appellant, the Appellant has received income from a wide range of banking and financial activities such as:

1. Interest income
   (a) interest income from loans and advances to customers;
   (b) interest income from treasury bills and treasury bonds & placement with other banks;
   (c) interest income from debenture investment
2. Other income
   (a) income from discounts on bills;
   (b) income from net foreign exchange gain;
   (c) dividend income from securities;
   (d) fees and commission income;
   (e) profits on sale of fixed deposits;

(f) other income.

[75] According to the financial statement of the Appellant, the Appellant has incurred expenses from the following banking and other financial activities:

1. Interest expenses
   (a) Deposits from customers;
   (b) Borrowing from banks.
2. Operating expenses
   (a)Auditor's remuneration;
   (b) depreciation;
   (c)financial VAT;
   (d)EPF & ETF
   (e)litigation
   (f)other

[76] In my view, the income of the Appellant from its banking business which includes dealing with deposits, borrowing, loans, investment, commission, discounts, sale of fixed deposits, securities, and other connected banking activities is income from the same source and whatever accrues in the form of interest, whether from securities, or loans or investment. It would fall under section 3(a) unless it can be clearly separated from its banking business because all the interest accrues from the business carries on by the Appellant is only one banking business, with several branches.

[77] It is manifest that the interest earned by the Appellant is not its sole business, and its income is not derived from interest alone. The Appellant has received income from loan and advances, treasury bills and treasury bonds, debenture investment and other income including dividends, commission discounts, foreign exchange gain, and sale of fixed deposits etc. During the course of the submissions made on 28.11.2022, Mr. Ameen admitted that the Appellant's core business is the interest income earned from its banking income, but submitted that interest income has been separated from the audited statement of accounts and therefore, it has been separately identified.

[78] Had the earning of interest been the sole or separate business of the company, then, the interest alone stands on a separate footing and falls within the term "interest" under section 3(e) of the IRA. If it falls under section 3(e), special deduction rule in section 25(1)(f) read with 25(4), subject to section 26 would apply to expenses. In other words, if the interest is not sole or separate

business of the Appellant, it would fall within the words "profits from any business" under section 3(a) of the IRA. In such case, the ordinary rule of deduction under section 25(1) would apply to outgoings and expenses.

[79] That matter does not end there. The issue here is the application of the tax exemption under section 9 of the IRA 2006 where the income falls either within the meaning of section 3(a) or 3(e) of the IRA. I will be shortly dealing, in this judgment, with the applicability of tax exemption under section 9 where the profits and income falls under section 3(a) of the IRA 2006.

[80] It is manifest that the business of the Appellant does not consist in the receipt of dividends, interest or discounts alone and its earning consists of several other sub-sources of core business activities. Applying the first part of the test adopted by Howard C.J. and Keuneman J., the Appellant would not fall within the ambit of the first element of the test and therefore, section 3(e) would not apply to the Appellant under the first element.

[81] I will now turn to the second element of the test. The Appellant however, relies on the second part of the test adopted by Howard C.J. and Keuneman J. and argues that section 3(e) applies on the basis that interest received by the Appellant can be clearly separated from the rest of the business and the interest received has been separately quantified for the purpose of tax liability.

[82] A perusal of the financial statement reveals that the Appellant carried on one banking business, which consists of several branches, viz, the earning of interest, dividends, commission, discounts, sale of fixed assets, foreign exchange gain etc. The business income from such branches is derived by the Appellant by using the funds collected from the depositors through the acceptance of money deposits for loans, advances, investments or any other operations authorized by law and by customary banking practices.

[83] The Appellant is not an investment company like in the case of CFI case. There is nothing to indicate that the interest was earned by the Appellant solely from a capital investment made by the Appellant, which has no connection whatsoever, with the funds received by the Appellant from the public through the acceptance of money deposits, or that a capital investment alone was used for all investment or granting loans to customers or the Government of Sri Lanka. A banker thus derives its income for its business as a banker and it does not acquire another source of income if part of the capital employed in the business is held in the form of securities. The interest he received for the

securities is income from the business of banking (*Huges v. Bank of New Zealand* 21 TC 472). The interest received by a bank on overdrafts or loan accounts or investment by employing moneys employed in the banking business are receipts of the banking business, and therefore, they cannot be classified as a separate business carried out by the Bank.

[84] It is clear from the financial statement of the Appellant that the interest is embedded in the banking business of the Appellant and thus, it cannot be separated from the ordinary banking business of the Appellant. The mere reference to separate entries in the audited statement of accounts, in the absence of separate accounts maintained by the Bank cannot show that the Appellant carried on a separate business, and derived interest income only from such business, which is not embedded in the banking business of the Appellant.

[85] On the facts and circumstances of the case, I am of the opinion that the interest earned by the Appellant cannot be regarded as the sole or separate business of the Appellant. I am of the view that the income derived by the Appellant from interest cannot be separated from the profits earned by the Appellant from its banking business, as it is embedded in its banking business activities. I accordingly hold that in the present case, the income derived by the Appellant from interest falls within the words "profits from business" under section 3(a) of the IRA 2006. I do not find any force in the argument of Mr. Ameen that the interest income earned by the Appellant Bank falls within the term "interest" under section 3(e) of the IRA 2006.

Is the Appellant disentitled to the exemption under section 9 where the income earned falls within the words "profits from business" under section 3(a)?

[86] It was the initial contention of Mr. Ameen that as the interest income in question falls within the meaning of section 3(e), such interest income should be exempt in terms of section 9(b) and 9(d) of the IRA 2006. At the hearing on 28.11.2022, Mr. Ameen however, drew our attention to the stand taken by the Appellant's Representative, Mr. Jayanethi, before the TAC (p. 153 of the brief) that the treatment of interest as business profits does not preclude the grant of exemption to the Appellant since the interests contemplated in sections 9(b) and 9(d) are falling to be treated as business profits. The contention of Mr. Balapatabendi was however, that where the interest in question falls within the meaning of section 3(a), the exceptions under section 9 are not applied to the Appellant.

[87] Now the question is whether the exemption claimed by the Appellant under section 9 applies to the source of profits and income earned by the Appellant under section 3(e) of the IRA 2006 only, or where the source of income falls exclusively under section 3(a), the exemption under section 9 is inapplicable to the Appellant. In other words, the question is whether, the classification of the interest as business profits under section 3(a) precludes the Appellant from claiming the benefit to the exemption under section 9 of the IRA 2006.

[88] The TAC in its determination first held that the legislature did not intend to grant special benefits to a specific bank, such as the Appellant under section 9 (b) and 9(d) and disallowed the exemption claimed by the Appellant under section 9(b) and 9(d). The TAC further held that the banks fall into a special category due to the requirements provided for in section 2 of the Banking (Amendment) Act, No. 33 of 1995. The TAC further said that distinct provisions apply under the Banking (Amendment) Act to banks incorporated in Sri Lanka and those incorporated outside Sri Lanka. The TAC held that therefore, unless the legislature specifically exempted specific banks such as the Appellant from section 9 of the IRA, 2006, it is not entitled to the exemptions under section 9. The TAC at pp. 26-27 stated:

> *"On considering the provisions of section 9 (b) which deals with exemptions from income tax of interest accruing to any "COMPANY", section 9(d) refers to ANY PERSON dealing in a specialized activity such as banking, which appears to have been given a special meaning vide the provisions of the Banking (Amendment) Act, No. 33 of 1995 to mean "the business of receiving of funds through acceptance of money deposits payable upon demand by cheque, draft or otherwise and the use of such funds either in whole or in part for advances or any operation either authorized by law or by customary banking practices" clearly showing that "BANKS FALL INTO A SPECIAL CATEGORY DUE TO REQUIREMENTS PROVIDED FOR IN SECTION 2 THEREOF. In that content it appears reasonable to assume that, had the legislature intended to exempt interest as claimed by the Appellant the former could have specifically done so vide provisions in the Inland Revenue Act itself. This contention appears apparent when we consider the provisions relating to incorporation of banks in Sri Lanka and those incorporated outside Sri Lanka. The requirements are clearly different. If the legislature intended special benefits to a specific bank, such provision as stated above could have been inserted in the Act itself".*

[89] The second is that the TAC disallowed the exemption under section 9 (d) on the basis that the exemption under section 9(d) applies only to an individual as opposing to a banking business. The third reason given by the TAC is that

the exemption under section 9(d) applies to the source of income falling within the meaning of section 3(e) and not trading income contemplated under section 3(a). The fourth reason adduced by the TAC in disallowing the exemption is that section 99 of the IRA 2006 precludes the Appellant from claiming the exemption under section 9 of the IRA. For those reasons, the TAC concluded at p. 28:

> *"Hence, it is manifest that the Appellant is a bank carrying on business receiving interest income falling within the provisions of section 3(a) of the Inland Revenue Act, No. 10 of 2006 and not eligible for exemption, but changeable with tax"*.

[90] I will now turn to the findings of the TAC in disallowing the exemptions under section 9(b) and 9(d) of the IRA 2006. Section 2 (1) of the IRA provides that income tax shall, subject to the provisions of this Act, be charged at the appropriate rates specified in the First, Second, Third, Fourth and Fifth Schedules to this Act ….in respect of every person for that year of assessment. Section 3 which enumerates the sources of income chargeable to income tax and all income from whatever source derived is therefore chargeable to income tax.

[91] The income chargeable to tax enumerated in section 3 is the rule and the exemptions granted are exceptions to the rule. The use of the words "Income tax shall, subject to the provisions of this Act" in section 2(1) means that the income from whatever source derived is subject to the provisions of the IRA 2006, which signifies that the income chargeable with tax in section 3 is subject to the exceptions under section 9 of the Act. It would make the words "income tax shall, subject to the provisions of this Act" no meaning, if section 9 can only be engaged where interest is attributable to section 3(e) alone. If that the true meaning, no exemption is permissible from interest income under section 9 where the income falls within the meaning of section 3(a), and if so, the exemption in section 9 is meaningless.

Exemptions under section 9 of the IRA 2006

[92] A perusal of the TAC determination reveals that it has taken the view that only the interest income derived from a source under section 3(e) falls within the exemption under section 9, and that the exemption was not available in regard to income derived from banking business under section 3(a). The legislature has however, allowed the following interest accrued to any person to be exempted from income tax:

1. The interest accruing to any person outside Sri Lanka, from any security, note or coupon issued by the Government of Sri Lanka in respect of a loan granted in foreign currency (9(b);

2. The interest accruing to any person on moneys lying to his credit in foreign currency in any account opened by him or on his behalf, in any commercial bank or in any specialized bank (section 9(d);

3. The interest accruing to any person on moneys invested in Sri Lanka Development Bonds in USD issued by the Central Banka of Sri Lanka 9(f).

[93] It may be noted that when the receipt of income of a particular kind is exempted from tax, the exemption attaches to such receipts irrespective the source from which the receipt is derived (Gooneratne, Income Tax of Sri Lanka, 2nd Ed. p/ 176). The exemption from tax of interest in section 9 makes a distinction between an individual and a body of persons (supra). All income from whatever source derived is therefore, is chargeable to income tax subject to exceptions set out in sections 7-24 of the IRA.

Effect of section 99 of the IRA 2006

[94] The assessor, Respondent and the TAC heavily relies on section 99 of the IRA to disallow the exemption to the Appellant on the ground that when the source of income falls within the meaning of section 3(a), the exceptions under section 9 have no application. The view of the TAC was that only the interest income derived from a source under section 3(e) falls within the exemption and that the exemption was not available in regard to income derived from banking business under section 3(a). Section 99 reads as follows:

> *"99. Where any provision of this Act expressly relates to any particular source of profits or income referred to in section 3, such provision shall not be applied in the determination of any profits or income arising from any other source referred to in that section".*

[95] According to the scheme of the IRA 2006, income tax has to be charged in respect of the "all profits and income" for that year of assessment of a person and "all profits and income" is defined under section 2(1) to comprise all "profits and income" or "profits" or "income" from whatever source derived from the heads specified in section 3, subject to certain exemptions. But what is significant is that profits and income or profits or income described in section 3 from whatever source derived is that section 3 is intended as describing different kinds of profits.

[96] The combined reading of sections 2 and 3, and shows that income tax is to be charged at the rate or rates prescribed in the IRA 2006 on the "all profits and income" of the person as defined in section 2(1) of the IRA 2006 and computed from the "all profits and income" of such person in the words of Viscount Dunedin in *Salisbury House Estate v. Fly* (1930) 15 T.C. 266:

> *"Now, the cardinal consideration in my judgment is that the income tax is only one tax, a tax on the income of the person whom it is sought to assess, and that the different schedules are modes in which the Statute directs this to be levied".*

[97] Viscount Dunedin, J. further stated that "there are no separate taxes under the various schedules but only one tax. But in order to arrive at the total income on which tax is to be charged, you have to consider the nature, the constituent parts, of his (assessee's) income to see which schedule you are to apply". Sir George Rankin in *Commissioner of Income Tax v. Chunilal B. Metha* (1938) 6 I.T.R. 521, further said:

> *"The effect of section 6 is to classify profits and gains, under different heads for the purpose of providing for each appropriate rules for computing the amount, its language is "shall be chargeable….in the manner hereinafter appearing".*

[98] These words are useful to consider under what head it appropriately and specifically falls, and if it falls under one particular head, then computation is to be made under the section which covers that particular head of income to which the particular tax rate applies. Thus, each head refers to income or profits attributable to the source –(i) trade, business, profession or vocation, employment, dividends, interests, discounts employment, rents, royalties etc. This supports the contention of each head being separate, exclusive and specific. However, it refers to the income of the person whom it is sought to assess, and such different heads are modes in which the Statute directs this to be levied according to the different rates, subject however, to exemptions.

[99] As Viscount Dunedin, J. held in *Salisbury House Estate v. Fly* (supra), the list of heads in section 3 contains a list of sources and one source is distinct from another source. He further held that there are no separate taxes under the various heads but only one tax, and the different heads are modes in which the Statute directs profits and or income is to be levied according to the different rates, subject however, to exemptions granted by the Act. Where the profits and income or profit or income expressly falls within any particular source under

section 3(a), such source applies to the determination of such profits and income, or profit or income under that source and none other is the principle behind section 99 and nothing more. In the result the assessor or the taxpayer has no option to elect the head under which the profits and income or profit or income can be determined by bringing it under any other head in section 3 of the IRA. This view is further fortified by the following statement of law contained in Volume 1 of Simon's Income Tax (1948 Ed.) p. 54:

> *"These schedules are prima facie mutually exclusive and consequently if a particular kind of income is charged under one schedule, the Crown cannot elect to charge it under another".*

[100] There is support for this proposition from the CFI judgment itself. In the CFI case, the attention of the Court was brought to section 47 of the Income Tax Ordinance, 1932, which is corresponding to section 99 of the IRA 2006. Section 47 of the Income Tax Ordinance, 1932 reads as follows:

> *"Where any provision expressly relates to any particular source of profits or income mentioned in sub-section (1) of section 6, such provision shall not apply to the determination of any profits or income which is assessable and has been assessed as falling within any other source mentioned in that sub-section".*

[101] His Lordship Keuneman J. referring to section 47 of the Income Tax ordinance, and the test applied to identify in what circumstances, dividends, interest or discount could fall within the ambit of section 6(1)(a) or 6(1)(e) rejected the argument of the Crown that the assessor has an option to choose between the various sources under section 6(1). His Lordship stated that the Crown has no option to elect between various sources under section 6 and charge the tax accordingly. Thus, the question whether dividends, interest or discount could fall either within section 6(1)(a) or 6(1)(e) will depend on the basis of the CFI test and not on the basis of any option elected by the assessor or the assessee. His Lordship Keuneman J., after formulating the test stated at p. 20:

> *"In my opinion, section 47 lends support to this. Section 47 applies to provisions expressly relating to any particular source under section 6(f) to that source and to none other".*

[102] It seems to me that where the interest earned is separate and distinct head under section 3(a), and if a profit or income is chargeable under that head, it is not open to the assessee to change the head, or to the assessor to charge the

tax under a different head. It is not possible to contend that where income falls under more than one head and say that the assessee has the option to choose the head which makes the burden on his shoulders lighter and rely on the other source.

[103] The intention of the legislature in introducing section 99 is to recognize the principle that (i) each head of income of which source has its characteristics for income tax purposes and falls under one specific head under section 3 of the Act; and (ii) where any item falls specifically under one head, it has to be charged under that head and no other. In other words, the principle under section 99 is intended to deny any option to the assessee or the assessor to elect any particular head under section 3 and prevent the assessor to charge the tax on any of the sources which may be chosen by the assessor because each head being, specific to cover the item arising from a particular source.

[104] Both precedent and on a proper construction of the scheme of the Act, the income from interest would fall under section 3(a) as it is chargeable within the terms "profits from business" and therefore, it cannot be brought under a different source [(section 3(e)]. This would mean that once an activity is properly characterized as a business, trade or profession or vocation under section 3(a), such characterization cannot be changed by the taxpayer, assessor and brought under a different source referred to in section 3 for the purpose of determination of profits or income of such person. The principle in section 99 is important in computing profits from a specified source in section 3 since a particular taxing rule will apply exclusively to that rule, and it cannot be brought under a different provision in section 3 to which a different rule applies.

[105] The rule in section 99 is not intended to deny the exemption granted to an assessee where his source falls within the words "profits from business, trade, profession or vocation" under section 3(a) and allow the exemption only where his source falls within the terms "dividends, interest or discount". Such an interpretation is absurd and mischievous to the true intention of the legislature expressed in the IRA 2006. It permits the assessor to charge the tax on all profits and income from whatever source derived subject, however, to the provisions of the Act, which includes tax exemptions.

[106] Silke on South African Income Tax, 3rd Ed. P.123 explains the nature of exempt income in a taxing statute as follows:

> *"Exempt income is simply income that is free or immune from tax in the same way as receipts or accruals of a capital nature, but there is a*

fundamental distinction between the two. A capital receipt completely lacks the quality of income and does not form part of the gross income except in certain exceptional cases. Except income on the other hand, by its very nature is included in the gross income, but does not form part of the "income"

[107] In my view, having regard to the intention of the legislature expressly granting an exemption under section 9 of the IRA 2006, the proposition enunciated by the TAC that unless the Appellant falls within the term "interest" under section 3(e), it would not be entitled to the exemption under section 9 is manifestly wrong and I reject that proposition of the TAC.

[108] For those reasons, I am of the opinion that the application of section 9 is not dependent upon the source of income under which interest received is classified. Accordingly, I hold that the exemptions under section 9 of the IRA 2006 are applicable to a taxpayer from whatever sources derived, notwithstanding a company's interest income falls under section 3(a) or 3(e), subject however, to **other conditions** set out in section 9.

Applicability of section 9(b) or 9(d) to a person or partnership

[109] Now the question is whether the conditions set out in the exceptions claimed by the Appellant under sections 9(b) and 9(d) have been satisfied by the Appellant to be eligible for the above-mentioned exceptions. The Appellant claims that the interest income of Rs. 104,525,902/- accrued to it on foreign currency loan granted to the Government of Sri Lanka upon Government security issued by the Government of Sri Lanka is exempt from income tax under section 9(b) of the IRA 2006. Section 9(b) reads as follows:

"9(b) The interest accruing to any person or partnership outside Sri Lanka, from any security, note or coupon issued by the Government of Sri Lanka in respect of a loan granted in foreign currency by that person or partnership to the Government of Sri Lanka, if such loan is-

(i) Granted prior to April 1, 2002, and approved by the Minister as being essential for the economic progress of Sri Lanka, or

(ii) Granted on or after April 1, 2012".

Conditions for the exemption under section 9(b)

[110] The interest accruing to any person under section 9 (b) is exempt from tax, provided that the following conditions are satisfied by such person:

1. The interest accrued to any person or partnership outside Sri Lanka;
2. The interest accrued to such person from any security, note or coupon issued by the Government of Sri Lanka;
3. The said Security should have been issued in respect of a loan granted in foreign currency by that person or partnership to the Government of Sri Lanka;
4. The said loan was granted prior to April 1, 2012;
5. The said loan was approved by the Minister as being essential for the economic progress of Sri Lanka.

Conditions for the exemption under section 9(d)

[111] The Appellant further claims that interest income accrued to it in a sum of Rs. 2,168,222/- on Euro deposits lying to its credit in another bank is exempt from income tax under section 9(d) of the IRA 2006. Section 9(d) reads as follows:

> *"(d) the interest accruing to **any person** on moneys lying to his credit in foreign currency in any account opened by him or on his behalf, in any commercial bank or in any specialised bank, with the approval of the Central Bank of Sri Lanka"*.

[112] The interest accrued to any person under section 9 (d) is exempt from tax, provided that the following conditions are satisfied by such person:

1. The interest accrued to any person on moneys lying to the credit in any account opened by him or on his behalf in any commercial bank or in any specificized bank;

2. The approval of the Central Bank of Sri Lanka should have been obtained for the relevant account for tax exemption.

Does the exemption under section 9(b) and 9(d) apply only to an individual?

[113] It is significant to consider whether the exemption from tax on interest in section 9(b) or 9(d) applies only to an individual as opposed to a person as stated by the TAC in its determination. A perusal of section 9 of the IRA reveals that the exemption applies to the following persons, company, partnership or other body of persons:

1. **a company or partnership or other body of persons outside Sri Lanka** is given exemption from tax on interest coming within paragraph (a) of section 9;
2. An **individual** is given the exemption from tax on interest that comes within paragraph 9(h) and 9(i);
3. **All persons** are given exemption from tax on interest coming within paragraphs (c), (d), (e), (f) and (g).

Who is a "person" within the meaning of the IRA 2006?

[114] On the face of the relevant provisions of section 9, it is crystal clear that the exemption in section 9(b) or section 9(d) applies to "any person" and the word "individual" is not used either in section 9(b) or 9(d). The word "individual" is used only in section 9(h) and 9(i) of the IRA 2006. If the intention of the legislature is to limit the application of section 9(b) or 9(d) to an individual, it could have easily used the word "individual" instead of using the word "person". Section 9(b) or 9(d) applies to "any person" and the word "person" is defined in section 217 as follows:

> *"person" includes a company or body of persons or any government".*

[115] Section 86(c) of Banking (Amendment) Act, No. 2 of 2005 defines a "company". "Company" means a company formed and registered under the Companies Act, No. 17 of 1982 and **any other body incorporated within or outside Sri Lanka**". However, the IRA 2006 defines a "company" and a "company" includes a company incorporated or registered under any law in Sri Lanka or elsewhere. A "company" is defined in section 217 often IRA as follows:

> *"Company means any company incorporated or registered under any law **in force in Sri Lanka or elsewhere**, and includes a public corporation".*

[116] Section 86(c) of Banking (Amendment) Act, No. 2 of 2005 defines a "company" as follows:

> *"Company" means a company formed and registered under the Companies Act, No. 17 of 1982 and any other body incorporated within or outside Sri Lanka".*

[117] A body of persons is defined in section 217 of the IRA as follows:

> *"Body of persons" includes any local or public authority, anybody corporate or collegiate, any fraternity, fellowship, association or society of persons, whether*

corporate or unincorporated, and any Hindu undivided family, but does not include a company or a partnership".

[118] It seems to me that the Appellant who is a company incorporated outside Sri Lanka and operating through a permanent establishment is a "person" within the meaning of section 9 (b) and 9(d) of the IRA read with section 217 of the IRA 2006.

[119] Section 28(1) of the IRA 2006 which relates to the basis for the ascertainment and computing the total statutory income uses the word "person" as follows:

> *"28(1). The statutory income of **every person** for each year of assessment from every source of **his** profits or income in respect of which tax is chargeable, shall be the full amount of the profits or income which was derived by **him** or arose or accrued to his benefit from such source during that year of assessment, notwithstanding that he may have ceased to possess such source or that such source may have ceased to produce income".*

[120] The only issue is whether the words "his" or "he" in section 28(1) applies only to an individual and not to a company or a bank. In the Blacks' Law Dictionary (11th Ed.) The word "he" is defined as follows:

> *"Properly a pronoun of the masculine gender, traditionally used and constructed in statutes to include both sexes **as well as a corporation**".*

[121] In the Law Lexicon Dictionary (2nd Ed.), the word "He" is defined as follows:

> *"The pronoun "he" when used in any Code, includes a female as well as a male, unless there is some express declaration to the contrary. The word "he", when used **in the Revenue act,** includes male, female, **company, corporation, firm, society, singular or plural number**".*

[122] The use of the word "person" in section 9(b) and 9(d) reflects the intention of the legislature that the legislature intended to apply the exemption to any "person", instead of any "individual" as correctly submitted by Mr. Ameen.

Does a "person" in section 9(b) or (d) exclude a bank?

[123] The TAC has further taken the view that the legislature has not specifically stated in section 9 (d) that a specific bank carrying on banking business within the meaning of the Banking (Amendment) Act, No. 33 of 1995 is entitled to the exception. In short, the TAC's view is that "any person dealing with any specialised banking activity within the meaning of the Banking (Amendment)

Act, No. 33 of 1995 is excluded from the tax exemption under section 9(d). It is relevant to note that section 2 of the Banking Act, No. 30 of 1988, relates to the licensing of **persons** carrying on banking business, and in terms of section 2(4), the Appellant Bank had been issued with a licence to carry on banking business as a commercial bank in Sri Lanka as set out in Schedule I of the said Acy (vide-item 17 of the Schedule). The long title of the Banking Act, No. 30 of 1988 reads as follows:

> *"An Act to provide for the introduction and operation of a procedure for the licensing of persons carrying on banking business and of carrying on the business of accepting deposits and investing such money; for the regulation and control of matters relating to such business; and to provide for matters connected therewith or incidental thereto"*.

[124] Section 2 of the Banking (Amendment) Act, No. 33 of 1995 replaced the long title of the Banking Act, No. 30 of 1988 and inserted the following long title:

> *"An Act to provide for the introduction and operation of a procedure for the licensing of persons-carrying on the banking business and of carrying on the business of accepting deposits and investing such money; for the regulation and control of matters relating to such business; and to provides for matters connected therewith or incidental thereto"*.

[125] It seems to me that there is no any major difference of the long title between the Banking Act, No. 30 of 1988 and the Banking (Amendment) Act, No. 33 of 1995. There is nothing to indicate in the language of section 9(b) or 9(d) that its application is limited to a company, which is not a company carrying on banking business in Sri Lanka through a permanent establishment when the definition of the "company" under section 86(c) of the Banking (Amendment) Act, No. 2 of 2005 includes a "company" formed and registered under the Companies Act, No. 17 of 1982 and any other body incorporated within or outside Sri Lanka. It is crystal clear that the Appellant commercial bank is a company both within the meaning of the Banking Act (as amended) and the IRA 2006 and therefore, it falls within the meaning of a "person" under section 217 of the IRA 2006.

[126] It is settled law that courts cannot usurp legislative function under the disguise of interpretation and rewrite, recast, reframe and redesign the Inland Revenue or add words to a provision, which are not contained therein, because this is exclusively in the domain of the legislature. In *R. v. Wimbleton Justices EX*.

P. Derwent (1953) 1 Q.B. 380, at 384, it was held that "a Court cannot add words to a statute or read words into it which are not there". In *Fernando v. Perera* 25 NLR 197, Jayawardene J. observed at p. 200 stated that "Courts have no power to add to the language of a Statute, unless the language as it stands is meaningless or leads to an absurdity". This proposition was lucidly explained by Lord Simonds in *Magor and St Mellons Rural District Council v. Newport Corporation* [1952] AC 189, HL. Referring to the speech of Lord Denning MR, Lord Simonds said at page 191:

> *"The duty of the court is to interpret the words that the legislature has used; those words may be ambiguous, but, even if they are, the power and the duty of the court to travel outside them on a voyage of discovery are strictly limited."*

[127] MR, Lord Simonds further said at page 192:

> *"It appears to me to be a naked usurpation of the legislative function under the thin disguise of interpretation and it is the less justifiable when it is guesswork with what material the legislature would, if it had discovered the gap, have filled it in. If a gap is disclosed, the remedy lies in an amending Act".*

[128] The same proposition was echoed by Arijit Pasayat, J. in the Indian Supreme Court case of *Padmasundara Rao and Others. v. State of Tamil Nadu and Others.* AIR (2002) SC 1334, at paragraph 14 as follows:

> *"14. While interpreting a provision the Court only interprets the law and cannot legislate it. If a provision of law is misused and subjected to the abuse of process of law, it is for the legislature to amend, modify or repeal it, if deemed necessary".*

[129] In *Cape Brandy Syndicate v. I.R.C.* [1921] 1 KB 64 at 71 (Ch D) that: (1921) Rowlatt J. stated:

> *"In a taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied, one can only look fairly at the language used".*

[130] The Appellant is a company incorporated in India and operating through a permanent establishment in Sri Lanka, and is liable to income tax in terms of section 2 and 97 of the IRA 2006 read with Article 6 of the DTAA between India and Sri Lanka. The Appellant being a company both within the meaning of the

Banking Act (as amended) and the IRA 2006 is a person to whom the tax exemption applies under section 9(b) and 9(d) of the IRA 2006.

Is the Appellant a person outside Sri Lanka?

[131] The next point is to consider whether the Appellant is a "person outside Sri Lanka" for the purposes of the exemption under section 9(b) of the IRA 2006 where it is deriving profits in Sri Lanka through a "permanent establishment" by virtue of the application of Article 5 of the DTAA between India and Sri Lanka.

[132] A company is resident in Sri Lanka under section 79 of the IRA 2006 where it has its registered or principal office in Sri Lanka or where the control and management of the business are exercised in Sri Lanka. Non-resident company in Sri Lanka means a company not falling within the meaning of section 79. Thus, the place of registration or place of principal office or the place of central management and control are the sole test of a company's residence.

[133] The concept of permanent establishment is relevant for assessing the income of a non-resident under the provisions of the DTAA between India and Sri Lanka. By virtue of Article 7 (1) of the DTAA, the business income of companies which are incorporated in India will be taxable only in India, unless it is found that they have permanent establishments (PE) situated in Sri Lanka. In such event, their business income may be taxable to the extent to which it is attributable to such PEs, would be taxable in Sri Lanka. The word "permanent establishment" is of course, a concept created by the DTAA for tax purposes, and it can be described as a taxable entity which is commonly used in all international Double Taxation Avoidance Agreements,

[134] Article 5 (1) of the DTAA defines the term "permanent establishment" as a "fixed place of business of an enterprise is wholly or partly carried on". It reads as follows"

> *"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on".*

[135] Article 5 (2) describes what permanent establishment includes. It reads as follows:

> *"2. The term "permanent establishment" shall include especially:*
>
> *(a) a place of management;*

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; (g) an agricultural or farming estate or plantation;

(h) a building site or construction or assembly project which exists for more than 183 days;

(i) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue within the country for a period or periods aggregating more than 183 days within any twelve-month period".

[136] The fundamental principle of the DTAA is that for the application of the DTAA, a person, whether an individual or company from one country (Country "A") will be taxable in the other country (Country "B") only if he has a permanent establishment (PE) in Country "B". Thus, if there is a PE, only the income attributable to such PE in Country "B" will be subject to tax in Country "B". Accordingly, a non-resident company will be liable to income tax in Sri Lanka if it carries on a trade in Sri Lanka through a permanent establishment (i.e., a branch or agency)

[137] It may be noted that the concept of permanent establishment is relevant for assessing the income of a non-resident under the DTAA but the concepts profits of business connection and permanent establishment should not be mixed up. While the business connection is relevant for the purpose of application of Sections 2 and 3, the concept of permanent establishment is relevant for assessing the income of a non-resident under the DTAA

[138] The Appellant is the Indian Overseas Bank, Colombi branch. It is not in dispute that the Appellant is incorporated in India and is resident in India. It is not in dispute that the Appellant a non-resident (foreign) company in Sri Lanka doing banking business through a permanent establishment in Sri Lanka. The Commissioner Mr. D. Ranagalle at page 163 of the TAC brief confirms this position as follows:

"It was revealed that the monetary Board of Sri Lanka has granted a licence to the Indian Overseas Bank of 763, Anna, Salai, Chennai 600002, India to carry on a domestic banking business at No. 139, Main Street, Colombo 11. So. Indian

Overseas Bank Colombo branch (hereinafter referred to as "Bank) is non-resident company doing business in Sri Lanka through a branch."

[139] I am of the view that the Appellant is a non-resident (foreign) company having a branch office in Sri Lanka and earning its profits and income from its business in Sri Lanka through a permanent establishment. The Appellant company can be treated as a permanent establishment (PE) with a registered branch office in Sri Lanka within the meaning of Article 5 of the DTAA between India and Sri Lanka. Accordingly, the Appellant company is subject to taxation in Sri Lanka, subject to any exemption or deduction, on the profits of a business carried on in Sri Lanka, through a permanent establishment located in Sri Lanka.

[140] However, it is only a branch of a foreign enterprise, which is resident in India, which is outside Sri Lanka. The fact that it has been granted a licence to conduct banking business in Sri Lanka does not change its legal status of a non-resident foreign company doing business in Sri Lanka. Thus, it will retain the residence of the parent company in India and so, it will be resident outside Sri Lanka for tax purposes, even though located within Sri Lanka through a PE.

[141] The TAC has interpreted the words "person outside Sri Lanka" to a person having a branch in Sri Lanka" merely because it has a branch in Sri Lanka, when the Appellant is only a branch of a foreign company, a resident in India, which is incorporated and located outside Sri Lanka. In my view the intention of the legislature is to encourage any person, which includes a non-resident (foreign) bank that grants foreign currency loans to the Government of Sri Lanka and exempt interest accrued on such banks from the interest derived from such loans, notwithstanding whether such company has a permanent establishment in Sri Lanka.

[142] In my view that a non-resident foreign company incorporated in India having a permanent establishment is a person outside Sri Lanka for the purposes of the IRA 2006. In this context, the exemption under section 9(b) applies to any person, which includes a non-resident (foreign) banking company, having a permanent establishment in Sri Lanka, that grants foreign currency loans to the Government of Sri Lanka for its economic progress. I hold that the exemption under section 9(b) applies to the Appellant who is a non-resident person and thus is a person outside Sri Lanka, notwithstanding whether such non-resident person has a permanent establishment in Sri Lanka.

[143] A tax exemption is granted by the legislature to provide relief to a person who would be otherwise liable to tax for the purpose of giving a measure of

relief and thus, it must be given its full effect unless, the conditions for its fulfilment are not met. In *Nanayakkkara v. University of Peradeniya* (1991) 1 Sri LR. 97, at p. 102, S.N. Silva, J. as he then was) expounded this proposition in the following words:

> *"A necessary corollary of applying the rule of strict construction to determine liability under a taxing statute, is that any provision granting an exemption from such liability be given its full effect. Exemptions are provided for by the Legislature for the purpose of giving a measure of relief to a person who would otherwise be liable to tax under the general rule. Therefore, no restriction should be placed on such provision by way of interpretation so as to defeat the purpose of granting such exemption".*

[144] For those reasons, I reject the contention of the TAC that section 9(d) applies only to an individual, and hold that the exemption under section 9(b) or (d) applies to "any person", which includes a bank. I am of the opinion that the Appellant is entitled to the benefit of the exception under section 9(b) and 9(d) of the IRA 2006 notwithstanding the profits and income derived from interest falls within the meaning of section 3(a) of the IRA, provided that the conditions stipulated in section 9(b) and 9(d) are fulfilled by the Appellant.

Exemption of interest income under section 9(b) on foreign currency loan granted to the Government of Sri Lanka

[145] In the present case, it is common ground that the Appellant had granted a foreign currency loan of USD 150,000,000 to the Government of Sri Lanka upon a security issued by the Government of Sri Lanka and an interest income of Rs. 104,525,902/- had accrued to the Appellant. It was never disputed by the assessor or the Respondent that the said loan was not granted to the Government of Sri Lanka for its economic progress and that it was not approved by the Minister in charge of Finance on behalf of the Government of Sri Lanka.

[146] At the hearing, Mr. Ameen drew our attention to the Facility Loan Agreement dated June 2008 (p. 143 of the TAC brief) entered into between the Government of Sri Lanka and the Finance Party (Appellant) and other lenders with standard Chartered Bank acting as an Agent. In terms of clause 12.2 of the Agreement, the Borrower (Government of Sri Lanka) is obliged to make all payments to the Appellant without any tax deduction, and where tax deduction is required by law, such payment by the borrower shall be increased.

[147] In terms of clause 12.3 of the Agreement, the Government of Sri Lanka is obliged to make all payments to the Finance Party (Appellant) in the event tax is

required to be paid by the Finance Party and tax imposed on any payment received by the Finance Party. Clause 12.3 reads as follows:

"Tax indemnity

(a) Without prejudice to clause 12.2 (Tax gross-up), if any Finance Party is required to make any payment of an account of Tax on or in relation to any sum received or receivable under or in connection with the Finance Documents (including any sum deemed for purposes of Tax to be received or receivable by such Finance Party, whether or not actually received or receivable), or if any liability in respect of any such payment is assessed, imposed, levied or assessed against any Finance Party, the Borrower shall (within three Business Days of demand by the Agent) indemnify the Finance Party which determines it has (directly or indirectly) suffered a loss or liability as a result against such payment or liability together with any interest, penalties, costs and expenses payable or incurred in connection therewith".

[148] The exception to this clause is clause 12.3(b) which provides that the above paragraph will not apply to any tax imposed by the jurisdiction in which the (i) Finance Party is incorporated, or (ii) the Facility Office is located. Paragraph (b) reads:

"Paragraph (a) above shall not apply:

(A) By the jurisdiction in which that Finance Party is incorporated; or

(B) By the jurisdiction in which its Facility Office is located.

Which is calculated by reference to the net income actually received or receivable (but, for the avoidance of doubt, not including any sum deemed for purposes of tax to be received or receivable by that Finance Party but not actually received or receivable) by that Finance Party).

[149] The Appellant Bank is incorporated outside Sri Lanka. The Agreement had been arranged by several international banks, including the Standard Chartered Bank acting as an Agent. The lender of the facility is the **Indian Overseas Bank** incorporated in India, and the loan was arranged by several overseas banks. There is nothing to indicate in the available Agreement with regard to the jurisdiction in which its Facility Office is located, whether it is located in the office nominated by the lender or any other Finance Party or in the jurisdiction in which the Agent is located.

[150] It is undisputed, however, that the Legislature has clearly recognized that the interest accruing to any person outside Sri Lanka for granting a loan to the

Government of Sri Lanka in foreign currency upon any security issued by the Government of Sri Lanka is exempt from tax under section 9(b) of the IRA 2006 subject to certain conditions.

[151] Exemption from tax under section 9(b) has been granted to encourage any non-resident person to provide a foreign currency loan to the Government of Sri Lanka for its economic progress upon a security issued by the Government of Sri Lanka, notwithstanding such a non-resident person carries on business in Sri Lanka through a permanent establishment (PE).

[152] In the present case, the following conditions set out in section 9(b) have been satisfied by the Appellant:

1. The Appellant granted a foreign currency loan (USD 150,000,000) to the Government of Sri Lanka, who issued a security in respect of such loan granted to the Government of Sri Lanka;
2. Interest income of Rs. 104,525,902 accrued to the Appellant from the Government of Sri Lanka;
3. The said loan was granted prior to April 1, 2012;
4. The Minister in charge of Finance, on behalf of the Government of Sri Lanka approved the said loan as being essential for the economic progress of Sri Lanka.

[153] For those reasons, I am of the opinion that the Appellant is entitled to the exemption of interest income amounting to Rs. 104,527,902/- on foreign currency loan granted to the Government of Sri Lanka under section 9(b) of the IRA 2006.

Exemption of interest of Rs. 2,168,222/- under section 9(d) on EURO deposits made by the Appellant with other Banks

[154] The Appellant claims the interest income of Rs. 2,168,222/- on Euro deposits with other banks is exempt from tax under section 9(d) of the IRA. The interest income derived by the Appellant from its banking business carried on in Sri Lanka and deposited in any bank is fully taxable, whether directly or through an agent under section 2 of the IRA 2006 read with DTAA between India and Sri Lanka unless it is specifically excluded from income tax under the IRA 2006 or the said DTAA.

[155] On the question whether the Appellant had obtained the approval of the central Bank of Sri Lanka to be eligible for tax exemption, as required by section

9(d), Mr. Ameen drew our attention to Part III of the operating Instructions, Circulars, Directions and Notices issued by the Central Bank of Sri Lanka on 03.07.2008 (see- docket in CA Tax 39/2014) and submitted that the Central Bank had granted general permission in terms of the provisions of the Exchange Control Act to all authorised dealers (licensed commercial banks) to accept investments in deposits at their domestic banking units from persons resident or outside Sri Lanka under certain conditions (Vide- page Ivi of the Circular).

[156] The relevant direction permitted, authorized dealers to accept investments in deposits in any foreign currency from any resident, non-resident, corporate body or incorporated outside Sri Lanka and foreign investors and maintain Foreign Investment Deposits (FIDA).

[157] The purpose of the direction is to attract foreign investment in Sri Lanka from resident or non-resident persons and corporate bodies incorporated outside Sri Lanka and deposit investment in foreign currency in any commercial bank in Sri Lanka. In the present case, the case stated does not indicate whatsoever, that the interest derived by the Appellant on euro deposits was either not derived from its banking business carried on by the Appellant in Sri Lanka or that such deposits were made in other commercial banks as a foreign investment in Sri Lanka.

[158] In this context, I am of the view that the intention of the legislature to exempt interest accrued to any person under section 9(d) is to attract investment in foreign currency through the banking system, and exempt the interest accrued on such deposits made in a commercial bank in Sri Lanka. In my view, the exemption applies to any person who actually invests his own money in foreign currency in any commercial bank opened by him or on his behalf, and claims interest accrued on such money lying to his credit. In my view, this exemption is not intended to benefit a bank that accepts deposits in foreign currency from customers in the course of its banking business and invests the same in other commercial bank in Sri Lanka unless the approval of the Central Bank is obtained and presented to the assessor or the CGIR or the TAC.

[159] In the present case, the Appellant has not produced a single document before the assessor, the CGIR or the TAC to show the nature of the foreign currency Euro deposit accounts opened by the Appellant and that the interest on euro deposits was not derived from the deposits of customers in the course of its banking business carried on by the Appellant in Sri Lanka using the depositors' moneys.

[160] For those reasons, I am of the view that the Appellant has failed fulfil the conditions set out in section 9(d) to be eligible for the tax exemption from euro deposits in a sum of Rs. 2,168,222/-.

Deductibility of expenses in a sum of Rs. 20,860,766/- referable to exempt interest of Rs. 74,218,923/- received on money invested in Sri Lanka Development Bonds

[161] It is not in dispute that the Appellant had invested in Sri Lanka Development Bonds and earned interest therefrom in a sum of Rs. 74,218,923/-. Section 9(f) of the IRA 2006 exempts interest accrued to any person on moneys invested in Sri Lanka Development Bonds in US Dollars. Section 9(f) reads as follows:

> *"the interest accruing on or before 31, march 2009, to any person on moneys invested in Sri Lanka Development Bonds denominated in United States Dollars issued by the Central Bank of Sri Lanka".*

[162] The assessor has permitted the tax exemption claimed by the Appellant under section 9(f) comprising interest income in a sum of Rs. 74,218,924/- earned by the Appellant on moneys in Sri Lanka Development Bonds. The assessor, however, disallowed the expenses incurred in the production of such income from the profits and income for the following two reasons:

1. The expenses incurred in the production of interest income which is exempt from tax should not be allowed when computing the profits and income which are included in the statutory income from trade, business, profession or vocation;

2. The Appellant has failed to maintain and prepare separate statements of accounts in a manner that the profits and income from exempt income can be separately identified and that the Appellant has failed identify separately the expenses incurred in the production of profits and income from Sri Lanka Development Bonds in the statements of accounts.

[163] Accordingly, the assessor estimated the said expenses in proportionate to the sum invested in Sri Lanka Development Bonds as follows:

$$\frac{\text{Exempt interest on USD Bonds}}{\text{Total Interest Income}} \times \text{Total Interest Expenses} = \text{Disallowable Borrowing Cost}$$

$$\frac{74,218,923}{756,826,340} \times 212,721,215 = 20,860,716/=$$

[164] The Appellant claims that the expenses incurred by the Appellant for Sri Lanka Development Bonds should have been allowed by the assessor for the following reasons:

1. It was deductible under the DTAA between India and Sri Lanka;
2. It was deductible under the principle laid down by the Supreme Court in *P.D. Rodrigo v CGIR* (2002) 1 Sri LR 384.

Article 7 of the DTAA between India and Sri Lanka

[165] The Appellant's first contention is that Article 7 (3) of the DTAA between India and Sri Lanka permits deductions to be made in respect of expenses incurred in the production of income of a permanent establishment and that the income refers to the entirety of the profits and income. It is not in dispute that DTAA applies to the Appellant who is carrying on banking business through a permanent establishment in Sri Lanka and that paragraph 3 Article 7 permits deductibility of expenses incurred for the purposes of the permanent establishment, whether in the State in which permanent establishment is situated or elsewhere.

[166] Article 7 of the DTAA provides as follows:

"Article 7- Business profits-

1. *The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:*

   (a) Sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment;
   (b) Other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.
   (c) Other business activities carried on in that other State of the same or similar kind a those effected through that permanent establishment.

   The provisions of sub-paragraphs (b) and (c) above shall not apply if the enterprise proves that such sales or activities are not attributable to the permanent establishment.

2. *Subject to the provisions of paragraph (3) of this article, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each*

Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment;

3. *In the determination of the profits of a permanent establishment, there shall be allowed as deduction expenses which are incurred for the purposes of the business of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other officers, by way of royalties, fees or other similar payments, in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, of except in the case of a banking enterprise, by way of interest on money lent to the permanent establishment. Likewise, no account shall be taken in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by a permanent establishment to the head office of the enterprise or any of its other sights, or by way of royalties, fees or other similar payments in return for the use of patents or other sights, or by way of commission for specific services performed or for management, or except in the case of a banking enterprise by way of interest on money lent to the head office of the enterprise or any of its other offices;*

4. *Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts nothing in paragraph (2), of the Article shall preclude that Constricting State from determining the profits to be taxed by such apportionment as may be customary; the method of apportionment shall, however, be such that the result will be in accordance with the principles contained in this article".*

[167] We may note that a non-resident permanent establishment operating in Sri Lanka generally receives equality of tax treatment in Sri Lanka compared with an Indian resident company through the operation of the non-discrimination article of the DTAA between India and Sri Lanka. It is not in dispute that the Appellant has paid tax on the interest in borrowing funds from its Central Office in India in a sum of Rs. 141,472,208 treating such interest as accrued from Sri Lanka to Bank of India. The CGIR has thus, allowed the said amount under Article 7(3) of the DTAA and the rate of tax applies for such

income was 10% as specified in Article 11(2) of the DTAA between India and Sri Lanka.

[168] The Appellant argues that it is entitled to deduct interest expenses under Article 7(3) of the DTAA between India and Sri Lanka as it has incurred expenses in earning interest income on Sri Lanka Development Bonds. If Article 7(3) applies, the Appellant must satisfy that it has actually incurred expenses for the purposes of earning interest income on Sri Lanka Development Bonds and identify such expenses separately in the statement of accounts. The Appellant however, seeks to deduct interest expenses both under the Provisions of the DTAA and the provisions of the IRA 2006.

[169] The main contention of Mr. Balapatabendi was that as the Appellant had got the benefit of the exemption under section 9(f), the Appellant is not entitled to the advantage of deducting the interest expenses of Rs. 20,860,766/- being expenses attributable to the earning of the interest income from Sri Lanka Development Bonds. In short, his argument was that the taxpayer is getting a double advantage, namely, he is getting his tax exemption in respect of interest from the Sri Lanka Development Bonds and he is also having the additional advantage of deducting the expenses incurred in the earning that interest. Mr. Balapatabendi justified the decision of the assessor in disallowing the expenses incurred in the production of income, and relied on the decision in *ICIC Bank Ltd v. Commissioner General of Inland Revenue* (C.A Tax 28/13 decided on 16.07.2015 in support of its contention that once the taxpayer is permitted a tax exemption with respect to a particular source of income, he will not be permitted a deduction of expenses incurred in the production of such income.

[170] In terms of Article 7(3) of the DTAA, in the determination of the profits of a permanent establishment, deduction of expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses shall be allowed. The IRA 2006 clearly says that the interest accruing to a person on moneys invested in Sri Lanka Development Bonds denominated in USD issued by the Central Bank is exempt from tax under section 9(f). Where expenses are truly and properly incurred in the production of interest income and identified separately in the statement of accounts, I agree that it could not be taxed indirectly by the inclusion in the profits and income of the taxpayer for the purpose of assessment.

[171] In *ICIC Bank Ltd v. Commissioner General of Inland Revenue* (supra), the main issue was whether or not the interest incurred by the bank was deductible in determining the profits from the trade of the bank in terms of section 25 or section 32(5) of the IRA 2006. Like here, the bank had invested money in Sri Lanka Development Bonds and claimed the exemption under section 9(f). The bank was given the benefit of exempting the income tax on accrued interest in Sri Lanka Development Banks. The bank claimed that the money it invested in the Sri Lanka Development Bonds denominated in USD issued by the Central Bank of Sri Lanka was the money that it borrowed from its depositors and therefore, the Appellant had to pay an interest to the said depositors. The bank claimed therefore, that the borrowing costs of the money invested in Sri Lanka Development Bonds shall be deducted from its taxable income. The State's contention was that the bank cannot have dual benefit and that he can only deduct the expenses incurred to generate the taxable income.

[172] Dehideniya J. first, took into consideration the bank's own assertion that the money it invested in Sri Lanka Development Bonds was the money it borrowed from its depositors in the course of its banking business and therefore, since, the bank has not incurred expenses in the production of profits or income as required by section 25 (1)(f) and 26(1)(g). The second was that the bank had already been benefited from the exemption under section 9(f) and therefore, the bank is not entitled to deduct interest expenses where the bank had not really incurred that expense to generate the taxable income. It is significant to reproduce the following statements made by Dehideniya J. at p. 3 of the judgment:

> *"The Appellant was given the benefit of exempting the income tax on accrued interest in Sri Lanka Development Bonds. It is a kind of loan given to the Sri Lankan Government by the Appellant. In appreciation, the government of Sri Lanka has given tax benefit from the accrued interest. How the Appellant finds money to invest in Sri Lanka Development Bonds is a matter of the Appellant. He cannot deduct any borrowing cost, if it is the only business he is doing in Sri Lanka. Therefore, it is my view that that the Appellant being engaged in businesses other than investing in Sri Lanka Development Bonds, cannot deduct any borrowing cost incurred in investing money in Sri Lanka Development Bonds from any other taxable income. If he is allowed, the Appellant will get dual benefit from the investment, that is to say the tax benefit in the accrued interest and deducting the incurred expense from taxable income* ***where he has not really incurred that expense to generate the taxable income.*** [Emphasis added].

[173] The third point raised by Dehideniya J. was that the Appellant had failed to maintain separate accounts under section 106(11) of the IRA 2006 and therefor, the only available method is to divide it according to a pro rata basis:

> *"The Appellant's argument is that the basis adopted by the Commissioner is arbitrary. The Respondent argues that the appellant has failed to submit separate accounts under section 106(11). Therefore, the only available method is to divide it according to a pro rata basis. As I have mentioned earlier, the Appellant has disregarded the law. Section 106(11) of the IRA imposes a duty upon the Appellant to maintain separate accounts, when it becomes necessary. Even though the Appellant has not produced any document or a separate account in this case, the Appellant stated at the inquiry that they are keeping all the data in their company. Still, they fail to submit them at the inquiry. Without conducting this business as required by law, the Appellant cannot be heard to say that the system adopted by the commissioner is arbitrary…".*

[174] The Court of Appeal in *ICIC Bank Ltd v. Commissioner General of Inland Revenue* (supra) only considered the deduction of interest expenses in terms of section 25(1)(f)/25(1)(g) and section 32(5) of the IRA 2006. It was not invited the consider the deductibility of expenses incurred in generating business income of the permanent establishment under Article 7(3) of the DTAA between India and Sri Lanka. In the present case, we are invited to consider whether the Appellant is entitled to deduct the expenses incurred in generating its interest income from Sri Lanka Development Bonds under Article 7(c) of the DTAA between India and Sri Lanka and in the alternative, under the provisions of the IRA 2006.

[175] In considering this question, we have to bear in mind that section 2 of the IRA 2006 applies in respect of the profits and income of any person including a permanent establishment who is liable for tax in Sri Lanka from all sources. The income from a source is ascertained in accordance with the general provisions of the IRA 2006 subject to any exceptions or deductions set out in the Act. It must be emphasized that the DTAA is not a new tax regime. If there is a conflict between the provisions of the IRA 2006 and the provisions of the DTAA for ascertaining the assessable income of a non-resident, in terms of section 97 of the IRA 2006, the provisions of the DTAA will supersede the provisions of the IRA 2006. In the *ICIC Bank Ltd v. Commissioner General of Inland Revenue* (supra), it was held that where the taxpayer has got a tax exemption from accrued interest from Sri Lanka Government Bonds, he cannot have a dual

benefit from expenses incurred in generating the taxable income under the provisions of the IRA 2006 where he has not really incurred that expense to generate the taxable income and that he has not identified its expenses separately under section 106(11) of the IRA 2006.

Deduction of interest expenses under the Provisions of the IRA 2006

[176] Having strongly relied on Article 7(c) of the DTAA 2006 for the deductibility of expenses, the Appellant, alternatively, relies on the decision of the Supreme Court in *P.D. Rodrigo v. CGIR* (2002) 1 Sri LR 384, which discussed the separation of income from different sources of business in one indivisible accounting business serving the locals as well as the foreigners in the same time. It is noted, however, in that case, the staff or the office or infrastructure was not divided for the locals and for the foreigners. In this context, the Supreme Court held that:

(i) the assessor was not entitled to make from the expenses on outgoings made on a pro-rata basis computed on the ratio of earnings in the local currency as to earnings in foreign currency;

(ii) where an assessee carries on an indivisible business and a part of its profits is not liable to tax, the entire expense for the purpose of the business should be allowed although a part of the expense may have been incurred for earnings the non—taxable profits.

[177] The interest income claimed by the Appellant on Sri Lanka Development Bonds was exempted by the assessor under section 9(f) of the IRA 2006. The Appellant seeks to deduct interest expenses under both systems. Having got the benefit in the accrued interest on Sri Lanka Development Bonds under section 9(f), the Appellant seeks to deduct the interest expenses under Article 7(3) of the DTAA. In this context, unless the provisions of the IRA 2006 are inconsistent with the provisions of the DTAA, the deduction of interest expenses, if any, will be governed by the provisions of the IRA 2006 and not under the provisions of the DTAA. The Appellant in the present case, has not made any submission on the question whether or not the provisions of the IRA 2006 are in conflict with the provisions of the DTAA and therefore, the provisions of the DTAA will apply to the deduction of expenses. The Appellant now submits that, if the provisions of the IRA 2006 apply, the interest expenses are deductible in terms of section 25(1)(f) as an "outgoing". The Appellant

claims that even if the interest expense cannot be considered as an expense incurred in the production of profits, it is entitled to deduct as it is a special deduction, under section 25(1)(f), notwithstanding section 26(1) and section 26(2) of the IRA 2006. Section 25(1)(f) reads as follows:

> *""25(1). Subject to the provisions of subsections (2) and (4), there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof, including-*
>
> ……
>
> (f)interest paid or payable by such person".

[178] Section 26(1)(g) however, provides that no deduction shall be allowed in respect of "*any disbursements or expenses of such person, not being money expended for the purpose of producing such profits"*.

[179] The Appellant who now relies on the special deduction rule under section 25(1)(f), must first satisfy that the Appellant has incurred expenses as an outgoing in relation to the interest income earned on Sri Lanka Government Development Bonds and identify such expenses separately from the interest income in the statement of accounts.

[180] Now the question is this: Is the taxpayer who has got the benefit of an exemption under section 9(f) entitled to deduct the expenses incurred in relation to such interest income where he has not truly and properly incurred such expenses and identified such expenses separately in his accounts. It may be noted that after the decision in *P.D. Rodrigo v. CGIR* (supra), Parliament amended section 106(11) of the IRA 2006 and made it necessary for any person or partnership carries on any business, trade, profession or vocation in several units or undertakings as one trade….,to maintain and prepare statements of account in a manner that the profits and income from each such unit or undertaking may be separately identified. Section 106(11) now reads as follows:

> *"Where any person or partnership carries on or exercises any trade, business, profession or vocation in several units or undertakings as one trade, business, profession or vacation, as the case may be, or where such person or partnership carries on or exercises more than one trade, business, profession or vocation and the profits and income from any such unit or undertaking or from such trade, business, profession or vocation is exempted from or*

chargeable with income tax at different rates, such person or partnership shall maintain and prepare statements of account in a manner that the profits and income from each such unit or undertaking or such trade, business, profession or vocation as the case may be, may be separately identified".

[181] In my view, the proper test is to consider whether or not the expenses were in fact incurred in the production of interest income from the investment of moneys in the Sri Lanka Development Bonds by the taxpayer and separately identified in its statements of accounts. Where the interest expenses are truly and properly incurred to generate the taxable income and identified separately in the accounts, the argument that the taxpayer is getting a double advantage, both from the tax exemption from interest income and deduction of expenses has no merits.

[182] However, where the taxpayer who got its interest income exempted from tax, under section 9(f), fails to show that it truly and properly incurred expenses, and fails to identify them separately in the accounts, he cannot have a dual benefit from both the tax interest exemption and interest expenses. If it is allowed, in such situation, the taxpayer will get dual benefit from the investment and an additional advantage of deducting the expenses not incurred to generate the taxable income.

[183] Now the crucial point is whether or not the Appellant has truly and properly incurred expenses in relation to Sri Lanka Government Bonds and identified such expenses separately in the accounts. The assessor has stated in his letter dated 22.03.2011 that (i) the Appellant has failed to identify the expenses incurred in the production of exempt interest from investment in Sri Lanka Government Development Bonds; and (ii) the expenses separately in the accounts; and (iii) maintain and prepare a statement of accounts in a manner that the profits and income from exempt income can be separately identified. He has allowed the interest income claimed by the Appellant under section 9(f) but disallowed the deduction of expenses said to have been incurred from investment in Sri Lanka Development bonds and calculated the expenses on a pro rata basis.

[184] A perusal of the audited statement of accounts of the Appellant reveals that it refers to accounting entries in respect of interest income (schedule I), interest expenses (schedule II) and other income (schedule III) (Vide- p. 113 of

the TAC brief). The relevant interest income and interest expenses in the audited statement of accounts are as follows:

INDIAN OVERSEAS BANK, COLOMBO – MAIN BRANCH
SCHEDULES FOR DETAILED ACCOUNTS
FOR THE YEAR ENDED 31ST MARCH 2009

SCHEDULE 1 – INTEREST INCONME

Interest on Loan	40,641,665,25	41,076,837
Interest on Cash Credit	95,394,192.58	44,788.246
Interest on Temporary Overdraft	17,975,079.00	1,559.621
Interest on Foreign Currency Loan	5,648,478,60	6,138,804
Interest on Foreign Currency Loan to Government	104,525,902.00	
Interest on Government Bonds & Foreign Currency Deposits	74,218,923.00	112,860,08
Interest on Investment (Treasury Bills)	341,260,242.11	105,003,022
Interest on Call Money	51,267,729.71	209,678,799
Interest on Euro Deposit with other Banks	2,168,222.00	817,214
Debentures Investments	23,725,906.41	33,017,759
	756,826,340,56	554.940.423

SCHEDULE II – INTEREST EXPENSES

Interest On Savings	3,912,328.00	4,242,541
Interest on Term Deposits	58,598,115.41	42,594,102
Interest on Call Money	128,527.67	0
Interest on TERMS deposits	4,883,195.00	1,330,720
Interest on RFG Deposits	100,018.00	170,607
Interest on EFC Deposits	357,866.00	1,261,053
Interest on NRFC A/C	287,710.00	972,029
Interest on RNNFC A/C	38,404,00	83,096
Interest on Foreign Deposits	809,851.00	317,271
Borrowings from Central Office	141,472,208.00	116,974,703
Borrowings from Banks	2,132,992.37	1,693,641
	212,721,215.45	169,659,762

[185] A perusal of the audited statement of accounts reveals that it identifies the interest on Government Bonds & foreign currency deposits amounting to Rs. 104,525,902/-. The relevant schedule II, however, does not clearly identify the expenses incurred in generating income on Sri Lanka Government Development Bonds attributable to the exempt interest (see- schedule II). No reference is made to any particular expenses in the audited statement of accounts in relation to Sri Lanka Government Development Bonds such as, for example, to executive and general management or administrative expenses or any other expenses incurred in generating income from exempt interest. The assessor says in his letter that from the audited statement of account, "*it is not*

possible to separately identify the attributable finance cost from your statement of account" and therefore, he calculated the borrowing cost attributable to the exempt and liable profit and income on a pro-rata basis.

[186] Unlike in the case of *P.D. Rodrigo v. CGIR* (supra), the issue in the present case is about the deductibility borrowing expenses incurred by the Appellant bank in generating non-taxable exempt income, which has not been separately identified by the Appellant in its audited statement of accounts. In any event, in *P.D. Rodrigo v. CGIR* (supra), the amount of the expenses was clearly identified by the assessee and the assessor from the exempt income derived from the services.

[187] At the hearing, Mr. Balapatabendi strenuously argued that the Appellant has deducted all interest expenses (Rs. 212,721,215.45) from interest income (Rs. 756,826,340.56) and calculated the taxable profits accordingly. He submitted that therefore, the Appellant is not entitled to deduct further expenses on Sri Lanka Development Bonds. A perusal of the audited statement of accounts (pp 113 & 121) reveals that the Appellant has deducted the interest expenses (Rs. 212,721,215.45 from its interest income (Rs. 756,826,340.56) and calculated the net income as Rs. 544,105,125.11) as reflected in the audited statement of accounts (page 121 of the TAC brief) as follows:

INDIAN OVERSEAS BANK, COLOMBO – MAIN BRANCH
INCOME STATEMENT
FOR THE YEAR ENDED 31ST MARCH 2009

		2008/2009	08
	NOTE	SL – Rs. Cts.	SL – RS.
INCOME	02	875,710,495.51	653,218,630
Interest Income	03	756,826,340.56	554,940,423
Interest Expense	04	(212,721,215.45)	(169,659,762)
Net Interest Income		544,105,125.11	385,280,661

[188] Having deducted all the interest expenses from interest income, the Appellant has added other income and other expenses and calculated the profit after tax (P. 121 of the TAC brief). The Appellant's audited statement of accounts, however, does not indicate that the Appellant has separately

identified the interest expenses incurred to generate the interest income from Government Development Bonds.

[189] In my view, the Appellant has failed to show that it has actually incurred expenses to generate exempt interest income from Government development Bonds and identify such expenses separately in the audited statement of accounts. The Appellant is not entitled to deduct the interest expenses either under Article 7(3) of the DTAA between India and Sri Lanka, or under the provisions of the IRA 2006.

[190] For those reasons, I am of the opinion that the Appellant is not entitled to deduct the interest expenses of Rs. 20,860,766/- from the profits and income on Sri Lanka Government Development Bonds, either under Article 7(3) of the DTAA between India and Sri Lanka or under the provisions of the IRA 2006 (s. 25(1)(f).

Conclusion

[191] For those reasons, I answer questions of law arising in the case stated as follows:

1. The Tax Appeals Commission erred in not allowing the interest income of Rs. 104, 525,902/- under section 9(b) of the Inland Revenue Act, No. 10 of 2006 on foreign currency loan granted by the Appellant to the Government of Sri Lanka;

   The Tax Appeals Commission is, however, correct in not allowing the interest income of Rs. 2,168,222/- under section 9(d) of the Inland Revenue Act, No. 10 of 2006, on Euro deposits made by the Appellant with other banks.

2. Yes. But the Appellant has failed to satisfy the conditions for the eligibility of the exemption under section 9(d) of the Inland Revenue Act, No. 10 of 2006;

3. Yes. But the Appellant has failed to satisfy the conditions for the eligibility of the exemption under section 9(d) of the Inland Revenue Act, No. 10 of 2006;

4. Yes, all judges in the CFI case did not say that section 9(3) should be uniformly applied to all interest received. Howard C.J. said that if the business of a company consists in the receipt of dividends, interest or discounts alone, or if such a business can be clearly separated from the rest of the trade or business, special provisions under section 9(3) will apply to such dividends, interest or discounts. Kenueman J. also said if the business of a company consists in the receipt of dividends, interest or discounts alone, or if such a business can be clearly separated from the rest of the trade or business, then any special provisions under section 9(3) applies to such dividends, interest or discounts. As regards the deduction of management expenses incurred in relation to dividends, Kenueman J. held that management expenses had been incurred in the production of the income and are necessary and reasonable expenses, and can be deducted under section 9(1). As regards, the deduction of interest earned by the company, Kenueman J. held that where the earning of interest has been the sole and separate business of the company, the special provision in section 9(3) would apply and if not, the ordinary rule under section 9(1) of the Income Tax Ordinance would apply, and the deductions claimed can be allowed in their entirety. Only Soertsz J. said that so far as interest is concerned, the special rule in section 9(3) modifies the general rule in section 9(1). Justice De Krester agreed with Justice Soertsz.

5. (a) The rule in section 99 is not intended to deny tax exemption granted to an assessee where his source falls within the words "profits from business, trade, profession or vocation" under section 3(a), and allow the exemption where the source falls within the terms "dividends, interest or discounts". It recognises the principle that where any item falls specifically under one head, it has to be charged under that head and no other. The answer to question of law No. 4 further apples.

   (b) The above answer applies.

6. The TAC has not considered the applicability of the DTAA between India and Sri Lanka. The Appellant has, however, failed to satisfy that it actually incurred expenses of Rs. 20,860,766/- in generating exempt interest from the Sri Lanka Government Development Bonds, and identify such expenses separately in the statements of accounts. Accordingly, the Appellant is not entitled to deduct the interest expenses either under Article 7(3) of the DTAA between India and Sri Lanka, or under the provisions of the IRA 2006.

7. The Appellant is entitled to the exemption claimed under section 9(b) of the Inland Revenue Act, No. 10 of 2006 in respect of interest income of Rs. 104, 525,902/- on foreign currency loan granted by the Appellant to the Government of Sri Lanka.

   The Appellant is, however, not entitled to the exemption claimed under section 9(d) of the Inland Revenue Act, No. 10 of 2006 in respect of interest income of Rs. 2,168,222/- on Euro deposits with other banks.

8. No. The Appellant is not entitled to deduct the entirety of the interest expenses in connection with Sri Lanka Government Development Bonds as the Appellant has failed to prove that it has really incurred such expenses to generate the taxable income and failed to identify them separately in the accounts.

9. Subject to our observations in this judgment, the TAC was correct in disallowing the interest income of Rs. 2,168,222/- under section 9(d) and the deduction of interest expenses of Rs. 20,860,766/-.

   The TAC is wrong in not allowing the interest income of Rs. 104,525,902/- under section 9(b) of the Inland Revenue Act, No. 10 of 2006 in connection with the loan granted to the Government of Sri Lanka. The Appellant is entitled to the tax exemption of interest income in a sum of Rs. 104,525,902/- on foreign currency loan granted by the Appellant to the Government of Sri Lanka;

[192] For those reasons, the case is remitted to the Tax Appeals Commission to revise the assessment in accordance with the opinion of this Court in terms of section 11(6) of the Tax Appeals Commission Act, No. 23 of 2011 (as amended). The Registrar is directed to send a certified copy of this judgment to the Tax Appeals Commission.

JUDGE OF THE COURT OF APPEAL

M. Sampath K.B. Wijeratne, J.

I agree

JUDGE OF THE COURT OF APPEAL