IN THE COURT OF APPEAL OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

In the matter of a Case Stated under Reference No. TAC/OLD/IT/018 by the Tax Appeals Commission under Section 170 of the Inland Revenue Act No. 10 of 2006 as amended

Boehm+Leckner Multi Moulds (Private) Limited,
No. 33 Ring Road, Phase 11, EPZ,
Katunayake.

Appellant

Case No. CA (TAX) 34/2014
TAC Case No. TAC/OLD/IT/018

Vs.

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

Respondent

Before: Janak De Silva J.

N. Bandula Karunarathna J.

Counsel:

F.N. Gunawardena with E.D. Wickremanayake for the Appellant

Farzana Jameel P.C. ASG with Suranga Wimalasena SSC for the Respondent

Argued On: 24.05.2019 and 29.08.2019

Written Submissions tendered on:

Appellant on 16.11.2018 and 14.10.2019

Respondent on 13.11.2018 and 10.10.2019

Decided on: 27.05.2020

Janak De Silva J.

The Appellant is a limited liability company incorporated and domiciled in Sri Lanka and its principal business activity is the manufacture of steel moulds, injection moulded plastic and rubber items for export.

The Appellant filed its income tax returns for the years of assessment 2006/2007 and 2007/2008 claiming a deduction for unrealised foreign exchange losses in a sum of Rs. 44,741,774/= and Rs. 36,962,328/= respectively.

The Assessor rejected the returns and issued fresh assessments on the Appellant disallowing the foreign exchange loss and the Appellant appealed to the Respondent who confirmed the assessments made by the Assessor.

The Appellant appealed to the Tax Appeals Commission (TAC) which dismissed the appeal and confirmed the determination of the Respondent.

Aggrieved by the determination of the TAC, the Appellant requested the TAC to state a case for the opinion of this Court and the Case Stated forwarded contains the following questions of law:

(1) Has the TAC erred in law in concluding that the foreign exchange losses incurred by the Appellant for the years of assessment 2006/2007 and 2007/2008 was capital expenditure in terms of section 26(1)(h) of the Inland Revenue Act No. 10 of 2006?

(2) Whether the foreign exchange losses incurred by the Appellant for the years of assessment 2006/2007 and 2007/2008 are an outgoing or expense which is deductible for income tax purposes in terms of section 25(1) and/or any other provision of the Inland Revenue Act No. 10 of 2006?

Before proceeding to examine these two questions in detail, it is apposite to state that sections 25 and 26 of the Inland Revenue Act No. 10 of 2006 as amended have to be read together as both provisions apply to the deductibility from profits or income. While section 25 specifies the permissible deductions, section 26 expressly disallows certain deductions, which if not so prohibited, would be allowable deductions.

Hence one must first ascertain whether what is sought to be deducted is permissible in terms of section 25 of the Inland Revenue Act No. 10 of 2006 as amended. If it is so, still the deduction may be prohibited in terms of section 26 of Inland Revenue Act No. 10 of 2006 as amended. Thus the learned counsel for the Appellant conceded during the argument that both the questions must be answered in favour of the Appellant for it to succeed.

I will therefore first examine question 2 raised on the application of section 25 of the Inland Revenue Act No. 10 of 2006 as amended and then proceed to examine question 2 based on the application of section 26 of the Inland Revenue Act No. 10 of 2006 as amended.

Outgoing or Expense

Section 25(1) of the Inland Revenue Act No. 10 of 2006 as amended reads:

> *"25(1). Subject to the provisions of subsection 2 and 4, there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoing and expenses incurred by such person in the production thereof..."*

Section 25(1) of the Inland Revenue Act No. 10 of 2006 is similar to section 9(1) of the Income Tax Ordinance. Basnayake C.J. having considered this provision opined in *Hayleys & Co. Ltd. v. Commissioner of Inland Revenue* (65 N.L.R. 174 at 175) held that:

> "The word "outgoings" means what goes out and is a word of wide import. It is the opposite of the equally wide expression "income" which means what comes in. In the context the word "expenses" is limited by the words "incurred by such person in the production thereof" while the words "outgoings" is not so limited. The two words are designed to express two different concepts one of wider import than the other. All outgoings are not expenses incurred in the production of the profits or income; but all expenses incurred in the production of the profits or income are outgoings..."

It is the Appellant's position that the foreign exchange losses were directly connected with the business and therefore was an expense incurred in the production of the Appellant [paragraph 26 of written submissions filed on 16.11.2018].

The meaning of the phrase "incurred in the production of the income" was explained by Watermeyer AJP in *Port Elizabeth Electric Tramways Company Ltd., v. CIF* [(1936) CPD 241, 8 S.A.T.C. 13] as:

> "...the purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible..."

Clearly, the words *expenses incurred by such person in the production thereof* to me means expenses actually expended and not a notional allocation.

The issue is put beyond any doubt when the relevant portion of the Sinhala version of section 25(1) of the Inland Revenue Act No. 10 of 2006 as amended is considered. It reads:

> **25**. (1) (2) වන සහ (4) වන උපවගන්තිවල විධිවිධානවලට යටත්ව, යම් ප්‍රභවයකින් ලැබෙන යම් තැනැත්තකුගේ ලාභ හෝ ආදායම නිශ්චය කිරීමේ කාර්ය සඳහා පහත සඳහන් දෑ ඇතුළුව, ඒ ලාභ හෝ ආදායම ඉපයීමේදී ඒ තැනැත්තා විසින් දරන ලද සියලු පිටයාම් සහ වියදම් අඩු කරනු ලැබිය යුතු ය—

This is the authoritative version in terms of Article 23(1) of the Constitution.

There is no dispute between the parties that the exchange losses in issue are *unrealised exchange losses* [paragraph 2 of letter dated 24.11.2010 sent by the authorised representative of the Appellant PWC to the Board of Review]. The Appellant is bound by an admission of fact made by its authorised representative. Hence they are not *expenses incurred by the Appellant in the production thereof* within the meaning of section 25(1) of the Inland Revenue Act No. 10 of 2006 as amended.

The learned counsel for the Appellant relied on the Sri Lanka Financial Accounting Standards - 2017 where at paragraphs 4.33 and 4.35 it is stated that the definition of expenses encompasses unrealised losses and it includes losses for example arising from the effects of increasing the rate of exchange for foreign currency borrowings of an entity.

The purpose of accounting is usually to provide information to interested parties relevant to stewardship, control and decision-making. The requirements of a tax system can be quite different. The profits and income shown in the accounts prepared in accordance with accounting standards differ from profits and income computed in accordance with the provisions of the Inland Revenue Act No. 10 of 2006 as amended.

In fact, the Supreme Court in *Rodrigo v. The Commissioner General of Inland Revenue* [(2002) 1 Sri.L.R. 384 at 387] held that to arrive at the taxable income consideration should be given only to the permissible deductions provided by the Act and the Court cannot take into consideration any other means of computing the deductible amounts. In doing so, it quoted with approval the decision in *Sub Nigel Ltd., v. CIR* [(1948) 4 SA 580, 15 S.A.T.C. 381] where Centilivers C.J. held that the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act.

I wish to add in passing that this is the approach taken by other jurisdictions as well.

In *Thor Power Tools Company v. Commissioner of Internal Revenue* [58L Ed. 2d.785 at 802 (1979)] the US Supreme Court stated:

> "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable".

For the foregoing reasons the answer to question no. 2 should be in the negative.

Capital or Revenue Expenditure

26(1)(h) of the Inland Revenue Act No. 10 of 2006 reads:

> *"(1) For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of*
>
> ...
>
> *(h) any expenditure of a capital nature or any loss of capital* ***incurred*** *by such person"* (Emphasis added)

As pointed out earlier, the word *incurred* means expenses actually expended and not a notional allocation as in the case of the Appellant.

The learned counsel for the Appellant referred to the decision in *Atherton v. British Insulated Helsby Cables* [10 TC 155] and in particular to the statement of Viscount Cave who stated:

> "...When ***expenditure is made***, not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of the trade, I think that there is very good reasons (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital." (Emphasis added)

It was further submitted that the Financial Statements of the Appellant for 2007 are clearly indicative that the Appellant was in serious financial difficulty during 2006/2007 and 2007/2008 and that the parent company B-L GmbH was providing temporary funding to keep the Appellant afloat and in these circumstances, the foreign exchange losses arising from the depreciation of the Rupee vs the Euro with respect to temporary funding cannot in any way be considered as *"expenditure made...with a view to brining into existence an asset or an advantage for the enduring benefit of the trade"* as set out in the dicta of Viscount Cave.

Yet, the dicta itself refers to expenditure made and not unrealised exchange losses as in the case of the Appellant. In this context, the decision in *Pattison (Inspector of Taxes) v. Marine Midland Ltd.* [(1984) A.C. 362 (HL)] is instructive.

There a subsidiary of a US bank in the UK matched its foreign currency obligations with foreign currency assets. The subsidiary borrowed a substantial amount of money from its parent company which it used to make loans in US dollars to its customers without converting the sum into sterling. The subsidiary regarded the loan from its parent company as a US dollar liability which it matched with US dollar assets. The subsidiary repaid the loan to its parent company, making use of US dollars which the subsidiary had.

During the period from its inception of the loan up to the date of repayment, the value of the US dollar against the sterling appreciated substantially, and the Commissioner in the UK sought to tax the book gain and disregard the equivalent book loss. The House of Lords rejected the Commissioners contention, and accepted the taxpayer's position that only profits realized should be converted to sterling amounts, as the Commissioner's position was predicated on a conversion of the principal sums into sterling amounts, without which the amount paid in US dollars would equal the amount borrowed and there would be no profit or loss to report in the company's tax return.

This decision supports the proposition that unrealised exchange loss due to currency conversion has no effect on the income and profit of an entity for income tax purposes.

Nonetheless, even on the question of capital or revenue transaction, whether loans were revenue transactions or accretions to capital is one of fact [*Beauchamp (Inspector of Taxes) v. F.W. Woolworth plc* (1988) Simon's Tax Cases 714].

In this context, it is observed that the Appellant has not charged the alleged foreign exchange loss to the profit and loss account. As the TAC correctly pointed out this shows that the Appellant regarded it as a capital expenditure in terms of section 26(1)(h) of the Inland Revenue Act No. 10 of 2006 as amended.

For the foregoing reasons the answer to question no. 1 should be in the negative.

For all the foregoing reasons, Court answers the questions of law as follows:

(1) Has the TAC erred in law in concluding that the foreign exchange losses incurred by the Appellant for the years of assessment 2006/2007 and 2007/2008 was capital expenditure in terms of section 26(1)(h) of the Inland Revenue Act No. 10 of 2006? **No.**

(2) Whether the foreign exchange losses incurred by the Appellant for the years of assessment 2006/2007 and 2007/2008 are an outgoing or expense which is deductible for income tax purposes in terms of section 25(1) and/or any other provision of the Inland Revenue Act No. 10 of 2006? **No.**

For the reasons aforesaid, Court confirms the Determination of the TAC.

The Registrar is directed to send a certified copy of this judgment to the TAC.

Judge of the Court of Appeal

N. Bandula Karunarathna J.

I agree.

Judge of the Court of Appeal