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/011 by the Tax Appeals Commission under Section 170(2) of the Inland Revenue Act No. 10 of 2006

CA (Tax) No: 28/2013

ICICI Bank Limited,
No.58, Dharmapala Mawatha,
Colombo 7.
APPELLANT

Vs.

The Commissioner General of Inland Revenue,
Department of Inland Revenue,
Sri Chittampalam A Gardiner Mawatha,
Colombo 2.
RESPONDENT

BEFORE : K.T. Chitrasiri, J. &
L.T.B. Dehideniya, J.

COUNSEL F.N. Gunawardhane with Sheranka Madanayake for the Appellant.
Arjuna Obeysekara DSG. for the Respondent.

ARGUED ON : 25.03.2015 &28.04.2015

DECIDED ON : 16.07.2015

L.T.B. Dehideniya, J.

THIS is a case stated for the opinion of the Court of Appeal by the Tax Appeals Commission under section 170 of the Inland Revenue Act No. 10 of 2006. Seven question of law have been raised seeking opinion of this Court. At the argument, the party requiring it to be stated (hereinafter referred to as the Appellant) agreed that the question nos. 1 and 7 need not be answered. The rest of the questions are as follows.

2 Does the Appellant carry on more than one trade, business, profession or vocation in terms of section 106 (11) of the Act?

3. Does the banking business which is carried on by the Appellant result in the Appellant having more than one source of income, as contemplated by the Act?
4. Was the interest incurred by the Appellant to the value of Rs.42, 475,326 deductible in determining the profits from trade of the Appellant for the year of assessment 2006/2007 in terms of Section 25 of the Act?
5. In the alternative, was the aforesaid interest incurred by the Appellant to the value of Rs. 42,475,326 deductible in determining the assessable income of the Appellant for the year of assessment 2006/2007 in terms of section 32(5) of the Act?
6. Notwithstanding the above, was the basis used by the Commissioner General of Inland Revenue in arriving at the interest expenses attributable to the investment made by the Appellant in Sri Lanka Development Bonds erroneous on law?

Appellant in this case is a bank incorporated in India and having a branch in Sri Lanka. Its primary business is banking, which includes providing loans to retail and corporate customers, lending to other banks, borrowing from other banks, issuing fix deposits to individuals, investing in treasury bills, investing in development bonds issued by the Government in Sri Lanka etc.

The Appellant has invested money in Sri Lanka Development Bonds. Under Section 9(f) of the Inland Revenue Act No. 10 of 2006 (IRA), the interest accrued to any person on moneys invested in the development bonds denominated in United State Dollars issued by the Central Bank of the Sri Lanka shall be exempt from Income Tax. The Appellant says that the money he invested in these bonds is the money that he borrowed from its depositors. Therefore the Appellant had to pay an interest to the said customers. The Appellant's argument is that the borrowing costs of the money invested in Sri Lanka Development Bonds shall be deducted from its Taxable Income. The state objects to this and argues that the Appellant cannot have dual benefit and he can deduct only the expenses which incurred to generate the Taxable Income.

Prior to consider the law, I'll consider whether the Appellant, as a reasonable person, can make such an application? The expenses that the Appellant wants to deduct from the Taxable Income are the expenses that he incurred to generate non Taxable Income. 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 has given tax benefit on the accrued interest. How the Appellant find money to invest in Sri Lanka Development Bond 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 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 it 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.

First question of law to be considered (question number two) is does the Appellant carry on more than one business. The Appellant is a bank.

Under Section 86 (interpretation section) of the Banking Act No.30 of the 1988, the banking business is defined 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";*

This Section defines the businesses that a registered bank under the Banking Act is allowed to engage within the meaning of "banking business". The bank cannot engage in any other business other than the banking business specified in the license. Section 6 of the Banking Act reads;

> *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 form of business other than those specified in Schedule II to this Act*

The purpose of defining the meaning of banking business in the Act is to limit the business that a bank is entitled to engage. Under the authority of this Section, the Appellant Bank is engaged in the following businesses.

- Providing loans to retail and corporate customers,
- Lending to other banks,
- Borrowing from other banks,
- Issuing fix deposit to individuals,
- Investing in treasury bills,
- Investing in development bonds issued by the Central Bank of Sri Lanka, etc.

The Appellant's argument is that all these businesses come within one business of "banking business". But these are separate businesses for the purpose of Income Tax. Section 3(a) of the IRA provides for the Income Tax to be charged on the profits of any trade or business. The section reads thus;

3. 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;

But Section 9(f) of the Act provides that the investment in Sri Lanka Development Bond is exempted from Income tax. The section reads;

9. There shall be exempt from income tax–

(f) the interest accruing to any person on moneys invested in Sri Lanka Development Bonds denominated in United States Dollars, issued by the Central Bank of Sri Lanka;

The Inland Revenue Act defines the investment in Sri Lanka Development Bonds in US Dollars as separate category of investment. The interest income derived from any investment comes within the meaning of "profit or income" and it is taxable under section 3 of the IRA, but special tax exemption was granted to the accrued interest in the said investment namely, the moneys invested in Sri Lanka Development Bonds denominated in United States Dollars. That means that the IRA has made the said investment a separate business of its own.

The Appellant's argument is that it is a part or a line of banking business, because as per the Banking Act investments are within the banking business. The words used in the Banking Act cannot be used to define the words in the Inland Revenue Act. As I have pointed out before, the words "banking business" is defined in the Banking Act for a different purpose. In the IRA, the businesses are categorized for the purpose of charging tax. Therefore, in the point of Income Tax, the Appellant is doing multiple businesses. My

opinion is that the Appellant carries on more than one trade, business, profession or vocation in terms of section 106(11) of the IRA.

The next question that has to be considered is whether the Appellant is having more than one source of income. As I have stated earlier, for the purpose of taxing, the Appellant is carrying on several business. Out of those businesses Appellant's sources of income are.

- Interest income from money deposits,
- Interest or dividend income from investment,
- Interest income from loans and advances,
- Interest from any other operations, etc.

The Appellant, within the scope of banking businesses; is engaged in multiple businesses at the same time and having separate sources of income. The learned DSG cited the case of Rhodesia Metals Limited vs. Commissioner of Taxes ([1940] 3 All E. R. 422) where the Privy Council held in an appeal from the Appellate Division of the Supreme Court of the Union of South Africa that, *"It is desirable to point out that - at any rate, for deferent taxing systems - income can quite plainly be derived from more than one sources, even where the source is business".*

Section 106(11) of IRA also recognizes that one entity can have several businesses. It requires that where a person carries on or exercise more than one trade, business, profession or vocation and the profits and income from such trade, business, profession or vocation are exempted from or chargeable with tax at deferent rates, such person shall maintain and prepare statement of accounts in a manner that the profits and income from each such activities may be separately identified.

In the case before us, investment in Sri Lanka Development Bonds is exempted from income tax. Therefore the Appellant is excepted keep a separate account. Unless he keeps a separate account, he will not be able to

obtain the tax benefit, because the tax benefit is granted only to the accrued interest in the investment of Sri Lanka Development Bond.

In the case of Rodrigo vs. Commissioner General of Inland Revenue ([2002] 1 Sri L.R. 384) separation of income from deferent sources of business is discussed. In that case the tax payer is an accountancy firm serving the locals as well as the foreigners. The income derived from providing services to the foreigners is exempted from the income tax. This being a firm serving the local as well as the foreign customers in the same time; the staff, the office, and other infrastructure is not divided for the locals and for the foreigners. The court held that it is one business. In the present case, the Respondent is not seeking for an order to separate the general expenditure. The issue here is the borrowing costs of the investment in Sri Lanka Development Bonds which is a specific expense incurred in earning a non taxable profit (interest income).

In the said Rodrigo's case Court observed that the Appellant was involved only in one professional activity, viz. as auditors rendering services of auditing, providing management and tax advice. Providing services to the foreign customers does not amount to a duality of professional activities, but only a sub sources within one main line of professional activities. In the present case before us, the situation is deferent. It is true that the Appellant is entitled to invest in the Sri Lanka development Bond within the scope of doing banking business. But it is a business that has to be kept separate account; it is a business that the government is giving a tax exemption. The Appellant may have invested the money that was deposited with him by its customers while doing the banking business of accepting deposits. Investing said money in Sri Lanka Development Bonds on a higher interest rate and with a tax benefit is not a part of the same business of accepting deposits. It is a separate business gaining a higher return. Therefore it is very clear that it is not a sub source of the main line of the income. It is a separate line of income. For the reasons stated above, my opinion is that the Appellant is having more than one source of income, as contemplated by the IRA.

Question No. 4 is on applicability of Section 25 of the IRA. The Section 25 1(f) provides that when ascertaining profit or income of any person from any source, all outgoings and expenses incurred by such person, in the productions thereof, including interest paid or payable by such person to be deducted. Under this Section, the meaning of the phrase "all outgoings and expenses incurred by such person in the productions thereof" must be considered. My view is that it means the outgoings and expenses incurred for the purpose of generating the taxable Income, and it is the one that can be deducted. The word "thereof" referred to the income generated by expending the said outgoings and the expenses. This concept is more clearly explained in Section 26(1) (g). It says "for the purpose of ascertaining the profits or income of any parson from any source, no deduction shall be allowed in respect of - any disbursements or expenses of such persons, not being money expended for the purpose of producing such profits or income". These two Sections have to be read together. It has been held in the Rodrigo case that any disbursement or expense which was not spent for the purpose of production of profits and income cannot be deducted and all outgoing expenses incurred by a person in the production of income could be included as deductions. Court further held that if any part of the expenses could be clearly identified as having been expended for the purpose of deriving money not been profits or income liable to tax such amount could not be deducted in terms of Section 26(1) (g) (Section 106(11) was introduced in to the IRA after this Judgment. Therefore there was no specific requirement to keep separate accounts at the time this Judgment was pronounced). Under these circumstances borrowing costs of the investments where the interest (income or profits) is exempted from income tax cannot be deducted under Section 24 & 25 of the IRA. As such, my opinion is that the interest incurred by the Appellant to the value of Rs. 42,475,236/- is not deductable in determining the assessable income of the Appellant for the year of assessment 2006/2007 in terms of section 25 of the IRA.

Next question of law is the applicability of Section 32(5) of IRA. The Section 32(5) (a) provides that there shall be deducted from the total statutorily income of a person for any year of assessment sums paid by such

person for any year of assessment by way of annuity, ground rent, royalty or interest not deductible under Section 25. But this Section is subject to certain conditions. The first proviso is that no deduction shall be allowed in respect of any such sum paid unless the assessor is satisfied that the recipient of such payment has issued a valid receipt for such payment containing name, address and the income tax file number (if any) of such person in Sri Lanka. In this case the Appellant has failed to produce any document to show that the names of the people to whom the interest paid and the amounts paid. This Section is subjected to another proviso that is no deduction shall be allowed in respect of such interest unless such interest is paid under any legal or contractual obligations. Appellant has failed to tender any document in proof of any contractual obligation or a legal obligation. Therefore my opinion is that the Appellant cannot rely on Section 32(5), and the interest incurred by the Appellant to the value of Rs. 42,475,236/- is not deductable in determining the assessable income of the Appellant for the year of assessment 2006/2007.

Question No 6. is in relation to the basis used by the Commissioner in arriving at the interest expenses attributable to the investment made by the Appellant in Sri Lanka Development Bonds. 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 Respondent to maintain separate accounts, when it become 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 computers. Still they failed to submit them at the inquiry. Without conducting the business as required by law, the Appellant cannot be heard to say that the system adopted by the commissioner is arbitrary, and the opinion of this court is that it is not bad in law.

For the foregoing reasons, the opinion of this Court on all questions of law raised in the case stated is that they be answered in favour of the Respondent. I direct the Registrar of this Court to remit the case with the opinion of this Court to the Tax Appeal Commission.

Judge of the Court of Appeal

K.T. Chitrasiri, J.

I agree

Judge of the Court of Appeal