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

In the matter of a case stated under Section 170 of the Inland Revenue Act No. 10 of 2006

Distilleries Company of Sri Lanka Plc
No.110, Norris Canal Road,
Colombo 10

CA/Tax
Case No. 13/13

Appellant

Vs

Commissioner General of Inland Revenue
Department of Inland Revenue
Sir Chittampalam A Gardiner Mawatha
Colombo 2

Respondent

Before: D.N. Samarakoon – J
C.P. Kirtisinghe – J

Counsel: Riad Ameen for the Appellant
Manohara Jayasinghe SSC for the Respondent

Argued On :03/03/2021
Decided On:03/08/2021

C.P. Kirtisinghe – J

The Appellant, Sri Lanka Distilleries Corporation of Sri Lanka PLC is engaged in the manufacture and import of liquor sold through registered

distributors and retailers (Licensees and wine stores). The assessor did not accept the return of income submitted by the Appellant for the taxable period 2006/2007 and the Appellant appealed to the Commissioner General of Inland Revenue. The Respondent Commissioner General of Inland Revenue in the determination dated 15.10.2010 confirmed the assessment of the assessor. The Appellant being dissatisfied with the determination of the Commissioner General of Inland Revenue appealed to the Board of Review but as the appeal was not concluded before the Board of Review the appeal got transferred to the Tax Appeals Commission. After considering the submissions made by both parties the Tax Appeals Commission had dismissed the appeal of the Appellant for the reasons set out in their determination dated 14/02/2013. Upon the application of the Distilleries Company of Sri Lanka PLC and under the provisions of Section 170 of the Inland Revenue Act No. 10 of 2006, the Tax Appeals Commission has stated this case for the opinion of this Court.

The Questions of Law raised by the Appellant in its application to the Tax Appeals Commission to cause a case to be stated are as follows;

1. Is the amount of Rs. 93,997,709 paid by the Appellant Company to the retailers in reimbursement of the extra Turnover tax paid by the retailers deductible in the particular circumstances of this case in terms of Section 25(1) of the Inland Revenue Act No. 10 of 2006 as an expenditure incurred in the production of income in the computation of the profits of the Appellant Company?

2. Is the conclusion of the Commission that the expenditure in question cannot be treated as an expenditure incurred in the production of income vitiated by the fact that the Commission has totally failed to consider the House of Lords decision in the case of **Usher's Wiltshire Brewery Ltd v Bruce**, a case of highest persuasive authority cited on behalf of the Appellant, which case has the highest degree of relevance to the present case in that, that case is also concerned about the expenditure incurred by the tax payer in relation to the business of some other persons and the tied tenants in which case are similar to the retailers in the present case?

3. Is the conclusion of the Commission that the expenditure in question is capital expenditure vitiated by the following circumstances?

    a. The Commission has unreasonably and erroneously acted on the assumption that the Appellant has argued that the reimbursement was made with a view to acquiring an enduring benefit whereas, as a matter of fact, no such argument was made by the Appellant. On the contrary, the submission of the Appellant was that "in the present case, the intention of the expenditure undertaken was not to bring into existence an asset or an advantage for the enduring benefit of the trade or business of the Appellant Company, the whole purpose of the expenditure was to deal with the question of the impact of the increased rate of tax on the profitability of the Company" (written submissions of the Appellant).

    b. The Commission has totally disregarded the decision in the case of **Commissioners of Inland Revenue v Carron Company** and the observation of Lord Reid regarding the nature of any advantage.

    c. The Commission has acted on the basis of the decisions of the cases of **John Smith and Son v Moore**, **English Crown Spelter Company v Baker and Theobold v Commissioner of Income Tax** which was neither relied upon by the Respondent nor was mentioned in the course of the proceedings relating to the appeal herein. The Appellant has had no comment on at least the applicability of the decisions and therefore, the Commission has violated the principle of natural justice *audi alteram partem* to the detriment of the Appellant.

4. Is the conclusion of the Commission that the payment in question is a capital payment the deduction of which is prohibited by Section 26(1) (h) of the Inland Revenue Act vitiated by the fact that such conclusion is arrived at on the basis of the reasoning in some cases which are irrelevant and therefore, inapplicable to the facts of the

present case, the cases being **John Smith and Son v Moore** (payment made on acquisition of a business, for unexpired contracts in the nature of capital assets), **English Crown Spelter v Baker** (an irrevocable loan written off considered as a capital payment) and **Theobold v Commissioner of Income Tax** (cost of temporary sheds which are treated as capital assets)?

There is no dispute regarding the following facts. There had been an increase in the Turnover taxes levied by some of the Provincial Councils from 01.01.2007 and the retailers had requested the Appellant to incur the said increase. Thereafter, the Appellant adjusted the prices to the satisfaction of the retailers with effect from 01.02.2007 which did not cover the month of January 2007. Instead, the Appellant reimbursed to the retailers the taxes paid by them in respect of the month of January 2007. The Appellant claimed this reimbursement as an expenditure incurred under Section 25(1) of the Inland Revenue Act No. 10 of 2006. The Respondent's case was that it cannot be allowed to be deducted as an expense as it is a capital expenditure under Section 26(1)(h) of the Act.

There were two issues to be resolved before the Tax Commission, namely;

1. Whether the assessment no. 8739159 issued to the Appellant Distilleries Company of Sri Lanka PLC for the year of assessment 2006/2007 was valid?
2. Whether the payments made to retailers/licensees as Turnover tax reimbursement, could be allowed as an expense or an outgoing in the production of income or profit of the Company for the year of assessment 2006/2007.

At the inquiry before the Commissioner General of Inland Revenue, the Commissioner had come to the conclusion that the assessment had been issued within the time frame, as mentioned in the Section 163(5) of the Inland Revenue Act No. 10 of 2006 and the reimbursement (payment) had no direct relationship with earning the income of the Appellant Company

as the reimbursement had been identified and had been made after the Appellant Company had earned the profits. In other words, “the decision of reimbursement to licensees has taken place after the month of January, means after realizing the profits on the sale of January”.

The Tax Appeals Commission also had come to the conclusion that the assessment no. 8739159 issued on the Appellant for the year 2006/2007 was valid, not time-barred and is in conformity with the requirements of Section 163(5) of the Inland Revenue Act No. 10 of 2006. The Appellant is not challenging that decision. With regard to the second issue, the Tax Appeals Commission has confirmed the determination made by the Commissioner General of Inland Revenue that the payment made by the Appellant has no direct relationship with the earnings of income (production of liquor) for the Appellant. The Tax Appeals Commission has come to the conclusion that it is not an outgoing or expense incurred in the production of its income. The Commission also has come to the conclusion that it is an expenditure attributable to capital and therefore, this expense is not deductible in terms of Section 26(1)(g) and (h) of the Inland Revenue Act No. 10 of 2006. Therefore, the matter in issue before this Court in the case stated is whether the reimbursement made by the Appellant to the retailers of the taxes for the month of January 2007 is capital expenditure or whether it is an outgoing or expense incurred in the production of its income. The learned Counsel for the Appellant argued that it is an outgoing or expense incurred in the production of its income. The learned Counsel for the Respondent argued that it is capital expenditure.

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

25(1) subject to the provisions of Section 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…

Section 26 of the Act reads as follows,

26(1) for the purpose of ascertaining the profits or income of any person from any source no deduction shall be allowed in respect of

(g) any disbursements or expenses of such person not being money expended for the purpose of producing such profits or income

(h) any expenditure of a capital nature or any loss of capital incurred by such person

The combined effect of Sections 25 and 26 of the Inland Revenue Act No. 10 of 2006 is to divide all outgoings into two categories namely, outgoings and expenses which are deductible and those which are not deductible.

In view of the provisions contained in Section 26(1)(h), expenditure of a capital nature is not deductible. In addition, disbursements or expenses not being money expended for the purpose of producing profits or income are also not deductible in view of the provisions contained in Section 26(1)(g). Under Section 25(1), all outgoings and expenses incurred in the production of income are deductible.

I will first consider the question whether this reimbursement is capital expenditure. The Tax Appeals Commission has come to the conclusion that it is an expenditure attributable to capital. In coming to that conclusion, the Tax Appeals Commission has relied on the judgment of **Atherton v British Insulated Helby Cables Ltd (10 TC 155)** and accepted the test laid down by Lord Cave in that case. In that case, Lord Cave had stated as follows. “Where an expenditure is made not only once and for all but with a view of bringing into existence an asset or advantage for the enduring benefit for the trade, I think there is very good reason (in the absence of special circumstances leading to the opposite conclusion) for treating the expenditure as property attributable not to revenue but to capital. The benefit or advantage may be substantive or it may be intangible or incalculable. But it must be a benefit or advantage which results in the appreciation of the asset that yields the income. “

In the case of **Vallambrosa Rubber Company v Farmer 1910 SC 519**, 5 T.C. 529, Lord Dunedin expressed the opinion that, “in a rough way it was not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be

spent once and for all and income expenditure is a thing which is going to recur every year and no doubt this is often a material consideration"

As Lord Cave had observed in the Atherton case the criteria suggested in the Vallambrosa case is not and was obviously not intended by Lord Dunedin to be, a decisive one in every case, for it is easy to imagine many cases in which a payment, though made "once and for all" would be properly chargeable against the receipt for the year. For an example, if a gratuity is paid to an employee on his retirement, which was the subject of the decision in **Smith v Incorporated Council of Law Reporting (1914)** 3 KB 674, it is attributable to the revenue expenditure although it is a once and for all payment.

For obvious reasons Lord Cave in the Atherton's case had widened the scope of the interpretation of "capital expenditure." The words "not only once and for all" in Lord Cave's description quoted above show that in addition to the requirement of a once and for all payment Lord Cave had introduced two more requirements namely,

2) The Expenditure is made with a view to bringing into existence an asset or advantage.

3) For the enduring benefit of the trade.

The learned Counsel for the Appellant argued that the aforesaid all three requirements are lacking in this case.

Before applying the test or criteria suggested by Lord Cave in the Atherton's case to the facts of the case before us, it is important to bear in mind the following observations of Viscount Radcliffe in the case of **Commissioner of Taxes v Nchanga Consolidated Copper mines Ltd** (1964) 1 All.E.R 208,

"Nevertheless, it has to be remembered that all these phrases, as, for instance 'enduring benefit' or 'capital structure' are essentially descriptive rather than definitive, and, as each new case arises for adjudication and it is sought to reason by analogy from its facts to those of one previously decided, a Court's primary duty is to inquire how far a description that was

both relevant and significant in one set of circumstances is either significant or relevant in those which are presently before us."

The same view had been expressed by Lord Pearce in the case of **B.P. Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia** cited by the leaned Counsel for the Appellant. In that case, Lord Pearce commenting on the criteria expressed by Lord Cave in Atherton's case states thus,

"those words are useful as an expression of general principle on prima facie indications, but the benefit in the particular case was the foundation of a fund that would endure for the whole life of the Company and provides no analogy to the present case."

The Commissioners in the Tax Commission have observed as follows. "Thus the Appellant argued that the reimbursement was made with a view of acquiring an enduring benefit for the business." The learned Counsel for the Appellant submitted that such an argument was never advanced on behalf of the Appellant. The oral submissions made before the Commission are not in the record. The Commissioners who heard the oral submissions made before them say that such an argument was made. Even assuming that the Appellant had made a submission to that effect the Tax Commission should come to an independent finding whether the reimbursement was made with a view of acquiring an enduring benefit for the business. As Lord Nueberger had stated in the case of **Secret Hotels Ltd Vs Revenue and Customs Commissioner (2014)** 2 All. E.R. 685 cited by the learned Counsel for the Appellant, "the label or labels which the parties have used to describe their relationship cannot be conclusive and may often be of little weight."

The Appellant adjusted the prices to the retailers with effect from 01.02.2007. Therefore, since 01.02.2007 the Appellant became liable to the price reduction. As the adjustment of prices did not apply for the month of January 2007, the Appellant reimbursed to the retailers the taxes paid by the retailers in respect of the month of January 2007. If you take this reimbursement in isolation, it is a once and for all payment. The learned Counsel for the Appellant submitted that it was (the price

reduction) incurred by the Appellant on a recurring basis. But for January, as there was no price adjustment, this sum was reimbursed. Therefore, it was submitted that in "substance" this was incurred by the Appellant on a recurring basis although in "form" it was a reimbursement and not a price adjustment. It was further submitted that it was not disputed at the hearing that in "substance" the effect was the same on the retailers. Quoting a passage from the judgment of Lord Atkinson in Atherton's case the learned Counsel for the Appellant submitted that "substance" will always prevail over the "form". In Atherton's case, Lord Atkinson had cited the judgment of **Royal Insurance Company Vs Watson (1897) A.C**. 1 in which case the Royal Insurance Company had purchased and acquired from the Queen's Insurance Company their whole undertaking which was regularly transferred to the purchasing company. In the agreement entered into between the two companies for this purpose, it was provided that the purchasing company should, until the transfer was completed, retain in their service the former manager of the Queen's Insurance Company at a salary of £ 4000 per annum. Liberty was reserved to the purchasing company to commute this salary by payment of a bulk sum calculated on the basis of certain tables in the agreement. The Appellant commuted this salary by payment of a sum of £ 55,8468. The Appellant Company contended that they were entitled, in fixing the amount of their liabilities to assessment for income tax to deduct this large sum from the gains and profit for the year in which payments had been made. It was held that this large sum of money was "in reality" a part of the consideration to be paid by the purchasing company to the vending company for the transfer by the latter to the former of the latter's business and was therefore money employed as capital within the meaning of the aforesaid rule 3. Lord Atkinson had looked into the substance of the transaction over the mere form of it. In **Sir Wroth Periam Christoper Lethbridge Baronet Vs Attorney General**, Lord Atkinson had stated thus "it has many times been decided that in dealing with questions arising on the finance act of 1894 and the succession duty acts **regard should be had to the substance of the transactions** on which these questions turn rather than to **the forms of conveyancing which the parties to them may have adopted** to carry out their objects".

The learned Counsel for the Appellant submits that in "substance" the effect was same on the retailers. In substance the reimbursement in January 2007 is the same **in effect** as the price adjustment for all months from February 2007. Therefore, it is the submission of the learned Counsel for the Appellant that **in substance it is not a once and for all payment** and **in reality, the sum is incurred** by the Appellant on **a recurring basis**. To come to the conclusion that in substance it is not a once and for all payment there have to be subsequent payments. In this case there are no subsequent payments made after January 2007. Price reduction is not a payment made to the retailers. It is not an expenditure incurred by the Appellant. Reduction of prices will no doubt cause a loss to the Appellant but that loss cannot be accounted for an expense incurred by the Appellant. Hence there is no recurring expenditure after January 2007. Therefore, one cannot come to the conclusion that the reimbursement made for the month of January 2007 was not a once and for all payment.

I will now consider the second ingredient of "capital expenditure"….with a view to bringing into existence an asset or advantage. To be capital expenditure it must be made with a view to bringing into existence an asset or advantage. Here there is no asset brought into existence by this reimbursement, but there is an advantage to the Appellant. That is the enhancement of good will. The Appellant Company had already created a good will from their customers and by this reimbursement that good will was enhanced. It only enhanced the good will which was already existing and this reimbursement did not bring into existence good will. Therefore, by this act of reimbursement the Appellant Company did not bring into existence "good will" and therefore, it cannot be treated as capital expenditure.

The third ingredient is the "enduring benefit". To be capital expenditure it must be made with a view to bringing into existence an asset or advantage for the **enduring benefit of the trade**. In this case no asset or advantage had been brought into existence by this reimbursement and therefore, the question of enduring benefit of the trade will not arise for consideration. Here there is no asset or advantage which had been brought into existence to consider whether it is for the enduring benefit of the trade. In any event,

the reimbursement of the tax paid for one month cannot bring any enduring benefit for the Appellant Company. Therefore, one cannot treat this reimbursement as capital expenditure.

In Atherton's case, the British Insulated and Helby Cables Company had formed a pension fund for the benefit of its employees and contributed a lump sum of money to form the nucleus of the fund. It was a once and for all payment and it brought into existence an asset or advantage in the form of a pension fund for the benefit of the employees of the Company and therefore, for the enduring benefit of the Company. But in this case, although the reimbursement was a once and for all payment it did not bring into existence an asset or advantage for the enduring benefit of the Company and therefore, it was not capital expenditure.

As this reimbursement is not expenditure of a capital nature, Section 26(1)(h) of the Inland Revenue Act No. 10 of 2006 will not be a bar to the Appellant. Therefore, one has to consider whether it can be allowed under Section 25(1) of the Inland Revenue Act No. 10 of 2006. Under that Section all outgoings and expenses incurred by a person in the production of income shall be deducted for the purpose of ascertaining the profits of income of that person. Section 26(1)(g) provides that any disbursements or expenses of a person, not being money expended for the purpose of producing such profits or income are not deductible for the purpose of ascertaining the profits of income of that person. The Commissioner General of Inland Revenue had come to the conclusion that the payment (reimbursement) has no direct relationship with earning the income of the Appellant Company. The Tax Appeals Commission also has come to the same conclusion and confirmed the determination of the Commissioner General of Inland Revenue.

The learned Counsel for the Appellant has relied heavily on the decision of Usher's Wiltshire Brewery Ltd v Bruce (Tax cases Vol 6 page 399) ([1915] A.C. 433). In their written submissions to the Tax Appeals Commission, the Appellant had drawn the attention of the Tax Appeals Commission to this judgment, but the Tax Appeals Commission has omitted to take that case into consideration. In that case the tenants of the Appellant's tied houses were under their agreement bound to repair their houses and to pay

certain rates and taxes. They failed to do so. The Appellant Company, though in no way legally or morally bound to do so, paid for these repairs and paid those rates and taxes. They did so, not as a matter of charity, but of commercial expediency in order to avoid the loss of their tenants and consequently the loss of the market for their beer, which they had acquired those houses for the purpose of affording. It was held that, though the Appellant Company were not legally or morally bound to make those payments, yet they were in estimating the balance of the profits and gains of their business for the purpose of assessment of Income Tax entitled to deduct all the sums so paid by them as expenses **necessarily** incurred for the purpose of their business.

The Tax Appeals Commission has come to the conclusion that the payment made by the Appellant is not an outgoing or expense incurred in the production of its income. In the case of **Smith Potato Estates v Boland** (30 TC 267) Lord Simmonds in taking into consideration the relevant rules has stated as follows. "In computing the amounts of the profits or gains to be charged, no sum shall be deducted in respect of any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purpose of the trade, profession, employment or vocation". Those words contained in the English rules are even stronger than the words contained in Section 26(1)(g) of the Inland Revenue Act No. 10 of 2006. According to those words, the expense should be **wholly and exclusively** incurred for the purpose of producing the profit and income of the business or trade. According to the words contained in Section 26(1)(g) of the Inland Revenue Act No. 10 of 2006, any disbursements or expenses not being money expended for the purpose of producing such profits or income shall not be allowed for deduction. The words contained in Section 26(1)(g) are wider in scope than the words in the English rule. But in both provisions, there has to be a nexus between the expense or disbursement and the production of profits or income.

There are similarities and dissimilarities between the facts in this case and the facts in Usher's case. In both these cases the tax payer incurred expenses of its customers. The tax payer paid/reimbursed the statutory dues of its customers. The tax payer was not legally bound to bear the

expenses. But in Usher's case it was necessary to do so. In Usher's case, the commercial expediency necessitated the tax payer to do so. If the tax payer Brewery did not pay the taxes and the rates payable by the tenants of the tied houses and did not pay for the repairs of the tied houses, the tax payer Brewery ran the risk of losing the tenants and consequently, losing the market for the beer they produced and therefore, it was necessary for the Brewery to incur that expenditure for the purpose of producing the profits and income of the Brewery. In this case, there was no such necessity. The Provincial Councils had increased the Turnover tax payable by the retailers with effect from January 2007. The Appellant had taken steps immediately to remedy the situation by reducing the wholesale price with effect from February 2007. Therefore, from February 2007 the increase of the Turnover tax did not cause any impact on the retailers and the Appellant continued to maintain the reduction of the wholesale price from February 2007 onwards. Thus, the Appellant had remedied the situation in a satisfactory manner and the retailers had nothing to complain. Therefore, it was not necessary to reimburse the taxes paid just for a month in view of the great benefit extended to the retailers by the Appellant. Therefore, one cannot expect the retailers to leave the Appellant in the event of the Appellant failing to reimburse the taxes paid by the retailers for the month of January. Therefore, one cannot come to the conclusion that the reimbursement is a necessary expense and an expense incurred by the Appellant in the production of profits and income. Therefore, it cannot be deducted under Section 25(1) of the Inland Revenue Act No. 10 of 2006 and both the Tax Appeals Commission and the Commissioner General of Inland Revenue has come to a correct conclusion in respect of this matter.

I answer the Questions of Law raised by the Appellant in this case as follows,

1. No
2. No
3. (a) Yes
   (b) Yes
   (c) Yes
4. Yes

Judge of the Court of Appeal

D.N. Samarakoon – J
I agree

Judge of the Court of Appeal