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 (as amended)

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

Appellant

Case No. CA/TAX/0005/2019
Tax Appeals Commission
No. TAC/IT/034/2016

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 : 30.07.2019 (by the Appellant)

01.10.2019 (by the Respondent)

Decided on : 27.01. 2023

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 05.02.2019 confirming the determination made by the Commissioner General of Inland Revenue on 02.12.2015, and dismissing the Appeal of the Appellant. The period relates to the year of assessment 2010/2011.

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.

[3] During the said assessment year, the Appellant invested a certain sum in Sri Lanka Development Bonds and received a sum of Rs. 63,449,772/- as interest receipt on the said Development Bonds. The Appellant submitted the return of income for the year of assessment 2010/2011 and claimed an exemption from income tax with regard to the said interest income of Rs. 63,449,772/- under section 13 (xxx) of the Inland Revenue Act, No. 10 of 2006 (hereinafter referred to as the IRA 2006).

[4] The Assessor by letter dated 22.11.2013 allowed the said exemption under section 13(xxx) of the IRA 2006, but disallowed the interest expense of Rs. 22,098,941/- referable to the said exempt income of Rs. 63,449,772/- on a proportionate basis.

[5] The assessor by letter dated 22.03.2011 refused to deduct the expenses claimed by the Appellant under the provisions of the IRA 2006 for the following reasons:

(a) As the interest income on Sri Lanka Development Bonds is exempted from income tax, borrowing cost which related to the exempt income on Sri Lanka Development Bonds, not being money expended for the purpose of producing the profits or income cannot be allowed in the ascertainment of profits or income;

(b) The Appellant failed to identify and maintain separate accounts for exempt income received on Sri Lanka Development Bonds in terms of section 106 (11) of the IRA 2006.

[6] The assessor did not allow the tax credit of Rs. 15,945,678/- under section 137 of the IRA 2006, but deducted the said amount from the profits from trade or business as expenses in the computation of the total statutory income.

Appeal to the Commissioner-General of Inland Revenue

[7] 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 dated 02.12.2015 confirmed the assessment (Vide- reasons for the determination at pp. 78-80 the Tax Appeals Commission brief).

Appeal to the Tax Appeals Commission

[8] Being dissatisfied with the said determination of the Respondent, the Appellant appealed to the Tax Appeals Commission (hereinafter referred to as the TAC) and the TAC, by its determination dated 05.02.2019 dismissed the appeal for the following reasons:

1. Article 7(3) of the Double Taxation Avoidance Agreement (DTAA) between the Government of Sri Lanka and India will not apply to the exempt interest relating to Sri Lanka Development Bonds;
2. The deductibility of interest expenses is governed by the provisions of the Inland Revenue Act and the direct interest expenses claimed by the Appellant under section 25(1) (f) of the IRS 2006 cannot be allowed in respect of expenses, not being money expended for the purpose of producing such profits or income under section 26(1)(g) of the IRA 2006;
3. The claimed borrowing cost of Rs. 22,098,941/-is the direct cost of Sri Lanka Development Bonds, which is really money expended for the purpose of producing exempt income allowed by the assessor;
4. It would not be logical to claim an exemption under section 13 (xxx) of the IRA 2006 while claiming the direct interest expenses under Article 7(3) of the DTAA;
5. The decision of the Privy Council in Patrick Reynolds *v. Commissioner of Income Tax Trinidad, Tobago*, (1967) AC 1, which interpreted the word “including” had undergone many changes after 1965, is not a precedent binding the Courts of Sri Lanka, and therefore, the said decision cannot be applied to support the argument of the Appellant that the expenditure specifically provided in section 25(1)(f) is deductible, whether or such expenditure had been incurred in the production of income;
6. The Appellant is engaged in several business activities and one such activity is the investment made on Sri Lanka Development Bonds, which is a

separate trading activity, which brings interest income and the direct expenses related to interest income should be separately deducted. The Appellant failed to identify the direct expenses from exempt interest and maintain separate accounts as required by section 106(11) of the IRA 2006. Therefore, the assessor had no option but to calculate the borrowing cost related to Sri Lanka Development Bonds, on pro-rata basis;

7. Although the Appellant separately claimed tax credit in a sum of Rs. 15,945,678/- in terms of section 137 of the IRA 2006, and the assessor did not allow the tax credit, the same amount of Rs. 15,945,678/- has been deducted by the assessor from the profits of the business as expenses, when arriving at the total statutory income. Therefore, the Appellant has been allowed to claim the said tax credit of Rs. 15,945,678/- for the year of assessment 2010/2011.

Appeal to the Court of Appeal & Questions of Law

[9] 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. Did the Commission err in law in deciding the issue in the case for determination, namely, the deductibility of the borrowing cost of the exempt interest of the appellant, on the basis of the provisions of the Inland Revenue Act, namely, the sections 25(1) and 26(1) (g) of the Act instead of deciding the issue on the basis of the provisions in Article 7(3) of the double Taxation Treaty between Sri Lanka and India, applicable to the year of assessment under consideration?

2. Did the Commission err in law in its failure to decide the issue referred to in the preceding question on the basis of the treaty provision, especially in view of the fact that the Inland Revenue representative himself conceded at the hearing held on 19th September 2017 that the deductibility of the expenses of the Colombo branch of the appellant which is a permanent establishment is a matter governed by Article 7(3) of the said treaty?

3. Even if it is assumed without conceding that the issue is governed by the provisions in the Inland Revenue Act, did the Commission err in law in its failure to act on the basis of the provision in section 25(1) (f) of the Act which is a special provision?

4. Did the Commission err in law in its failure to act on the basis of the Privy Council decision in the case of *Patrick Alfred Reynolds v. Commissioner of*

Income Tax, Trinidad & Tobago, which is of the highest persuasive authority though not legally binding on courts of Sri Lanka?

5. Did the Commission err in law in not making available to the Appellant the written communication of the Inland Revenue representative, made after the re-hearing of the case on 24th January 2019, in relation to the issue of allowability of the credits for tax withheld on interest income of the Appellant, thereby violating the principle of natural justice, *audi alteram partem*?
6. Did the Commission err in law when it treated the deduction of interest as an expense in the computation of the profits as a credit against tax, thereby depriving the Appellant of the benefit of a tax credit in a sum of Rs. 15,945,678 which was due to the Appellant even according to the Inland Revenue representative?

7. Did the Commission fail to properly examine and/or apply and/or appreciate the facts and the law relevant to the matter?

[10] 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 seven questions of law submitted for the opinion of the Court. Mr. Riad Ameen submitted that the determination of the TAC is erroneous for the following reasons:

1. Article 7(3) of the Double Taxation Avoidance Agreement (DTAA) between Sri Lanka and India applies to the deduction of expenditure incurred by a permanent establishment (PE) regardless of whether it is exempt income or not;

2. The deductibility of interest expense of the Appellant being a permanent establishment (PE) is governed by Article 7(3) of the Double Taxation Avoidance Agreement (DTAA) between Sri Lanka and India, and the TAC was wrong in deciding the deductibility of interest expense under the provisions of section 25(1) and 26(1)(g) of the IRA 2006;

3. Even if it is assumed that the deductibility of interest income is governed by the provisions of the IRA 2006, interest is deductible under section 25(1)(f) as it is a special rule of deduction despite section 26(1)(g). He relied on the decision of the Privy Council in *Reynolds v Commissioner of Income Tax Trinidad, Tobago* (supra) and *Rodrigo v. Commissioner of Inland Revenue* (2002) 1 Sri LR 384) to support his argument that the expenditure which is specifically provided in section 25(1)(f) is deductible, whether interest paid or payable, and whether such expenditure has been incurred in the production of income or not;

4. The interest expense claimed by the Appellant is an “outgoing” which is not limited to expenditure incurred in the production of profits or income, and therefore, it includes items irrespective of whether or not, they are “incurred in the production of profits or income. He relied on the decision of the Supreme Court *in Hayley and Company Ltd. v. Commissioner of Inland Revenue* 65 NLR 174 in support of his contention;

5. The prohibition of deduction in section 26(1)(g) only applies to “expenses” and “outgoings” referred to in the general rule of deduction in section 25(1) and not to the special rule of deduction specifically made for interest in section 25(1)(f) of the IRA 2006. Therefore, the prohibition of deduction in section 26(1)(g) does not take away the specific deductions permitted under section 25(1)(f) of the IRA 2006;

6. The Commissioner himself accepted in his written submission before the TAC on 25.01.2019 that the Banks and Financial Institutions are entitled to claim the tax credits in terms of section 137 of the IRA 2006 and therefore, the Appellant is entitled to claim the tax credit of Rs. 15,945,678/- in terms of section 137 of the IRA 2006.

[11] On the other hand, Mr. Balapatabendi submitted that the TAC was correct in dismissing the appeal filed by the Appellant for the following reasons:

1. The intention of DTAA is to avoid double taxation and prevention of fiscal evasion in respect of taxes on income and it does not provide double profit for any establishment both under the DTAA and IRA;

2. The DTAA deals with the taxes on income or profit which is charged by both contracting states (taxable income), but the DTAA does not cover exempt income (non-taxable income);

3. The Appellant has already got the tax benefit of exempting the income generated from interest under section 13(xxx) of the IRA 2006, in respect of the Sri Lanka Development Bonds and therefore, the Appellant cannot seek to deduct interest expenses incurred for the purpose of the same business, under Article 7(3) of the DTAA, which is a dual benefit in the accrued interest and incurred expenses;

4. Deductions specified in section 25(1) cannot be separated as general rule and specific rule, and the decision of the Privy Council in *Reynolds v Commissioner of Income Tax Trinidad, Tobago* (supra) cannot apply in Sri Lanka;

5. Even though section 25(1)(f) allows interest expenses are deductible under section 25(1)(f), section 26(1)(g), has limited such expenses to the money expended for the purposes of producing such profits or

income, and in the present case, the expenses claimed relate to expenditure incurred in the production of profits or income, which is not deductible under section 25(1)(g) of the IRA 2006.

Matters to be determined

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

1. Whether on the facts and circumstances of the case, the deductibility of interest expense of Rs. 22,098,941/- should be decided on the basis of the provisions in Article 7(3) of the Double Taxation Avoidance Agreement (DTAA) between Sri Lanka and India instead of the provisions of section 25(1) and 26(1)(g) of the IRA 2006;

2. If the deductibility of interest expense is governed by the provisions of the IRA 2006, interest income is exempt under the provisions of the IRA 2006, (a) whether the interest expense incurred by the Appellant is an outgoing within the special deduction rule under section 25(1)(f) of the IRA 2006; or (b) whether or not, such expense is incurred in the production of profits or income, despite the exclusion of deduction under section 26(1)(g) of the IRA 2006;

3. Whether on the facts and circumstances of the case, the Appellant is entitled to claim a tax credit in terms of section 137 of the Inland Revenue Act.

Analysis

Is the deductibility of interest expense in a sum of Rs. 22,098,941/- referable to exempt interest of Rs. 63,449,772/- received on money invested in Sri Lanka Development Bonds governed by the provisions in Article 7(3) of the Double Taxation Avoidance Agreement between Sri Lanka and India or the provisions of the Inland Revenue Act?

[13] The Appellant claimed an exemption for the interest income received from the Sri Lanka development Bonds amounting to Rs. 63.449,772/- under section 13(xxx) of the IRA 2006, and deducted the direct expenses relating to the interest income on the said Sri Lanka Development Bonds. The assessor only allowed the Appellant's claim for exemption from income tax in relation of the interest earned on Sri Lankan Development Bonds under section 13(xxx) of the IRA 2006. Section 13 (xxx) of the IRA 2006 reads as follows:

> *"an amount equal to the interest or the discount paid or allowed, as the case may be, to any person on or after April 1. 2009, on any Sri Lanka*

Development Bond denominated in United States dollars, issued by the3 central bank of Sri Lanka".

[14] Having got the benefit of exempting the income tax on accrued interest on Sri Lanka Development Bonds under section 13(xxx) of the IRA 2006, the Appellant seeks to deduct interest expense incurred for the purposes of the business of the Appellant being a permanent establishment (PE) under Article 7(3) of the DTAA between Sri Lanka and India. Article 7(3) of the DTAA between Sri Lanka and India reads as follows:

> *"the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purpose 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".*

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

[15] Now the question is whether the Appellant who claimed and got the benefit of exempting the income tax on accrued interest income on Sri Lanka Development Bonds under section 13(xxx) of the IRA 2006 is also entitled to deduct the interest expenses incurred for the business of investing money in the same Sri Lanka Development Bonds under Article 7(3) of the DTAA between Sri Lanka and India.

[16] It is common ground that the Governments of Sri Lanka and India entered into a Double Taxation Avoidance Agreement (DTAA) on 19.04.1983 which was recently revised in 2013. The DTAA is a contract between two Sovereign Governments of India and Sri Lanka. The Agreement has been signed by the two Sovereign Governments with full knowledge, understanding and free consent of both the Governments.

[17] 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–*
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> *(i) relief from income tax;*
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> *(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.*

[18] 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).

[19] There are two situations under which the relief can be achieved in Sri Lanka under the DTAA between India and Sri Lanka, one is relief by credit and the other is the relied by exemption/deduction. The two situations are as follows:

(a) Where income tax has been paid under the IRA 2006 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 (relied by credit); 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 (relied by exemption/deduction).

[20] 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) and where a DTAA applies, a similar principle applies with an additional concept of non-discrimination.

[21] 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 it is inconsistent with the provisions of the IRA 2006. As a consequence, if a tax liability is imposed by the provisions of the IRA 2006, 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.

[22] 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 is incorporated in India will be taxable only in India, unless it is found that they have a permanent establishment (PE) situated in Sri Lanka. In such event, their business income may be taxable to the extent to which it is attributable to such PE, and 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,

[23] 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".*

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

> *"2. The term "permanent establishment" shall include especially:*
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> *(a) a place of management;*
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> ***(b) a branch;***
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> *(c) an office;*
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> *(d) a factory;*
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> *(e) a workshop;*
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> *(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".*

[25] 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

[26] 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 Double Taxation Avoidance Agreement between India and Sri Lanka. 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 of 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.

[27] 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 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.

Article 7 (3) of the DTTA between India and Sri Lanka

[28] 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 for the purpose of its earning profits of its business in respect of Sri Lanka Development Bonds and that the income refers to the entirety of the profits and income. 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".*

[29] 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.

[30] As noted, the relief from double taxation in Sri Lanka is achieved under the DTAA between Sri Lanka and India either through the exemption/deduction from the tax being granted by Sri Lanka (generally the country of source) or where income remains taxable in both treaty countries, giving a tax credit.

[31] 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.

[32] Now the question is whether the Appellant is entitled to get the benefit of the deduction for interest expenses under the DTAA when it had been given the benefit of exempting income tax for interest income in respect of the same Sri Lanka Development Bonds under the provisions of the IRA 2006. The IRA 2006 clearly says that the interest accruing to a person on money invested in Sri Lanka Development Bonds denominated in USD issued by the Central Bank of Sri Lanka is exempt from tax under section 13 (xxx). The purpose of the DTAA is to make sure that people do not pay tax twice on the same income. The exemption for interest income is governed by section 13(xxx) of the IRA 2006 and the Appellant was given the benefit of exempting the interest income in a sum of Rs. 63, 449,772/- under section 13(xxx) of the IRA 2006.

[33] The Appellant claims that the deduction of interest expenses under Article 7(3) is not restricted to the expenses incurred in the production of income and covers expenses incurred for the purposes of the permanent establishment (PE) without setting out in detail the types of expenses, whether they are general management, administrative or executive or accounting expenses or any other expenses really incurred by the Appellant for the purposes of its business in relation to the same Sri Lanka Development Bonds.

Non-discrimination clause

[34] The Indo-Sri Lanka DTAA, has a non-discrimination clause in the form of Article 25 which prohibits taxation which discriminates against the nationals or individuals of the other treaty country. It permits a permanent establishment of a non-resident company to claim equal treatment with a domestic enterprise of the country in which it is situated and receive a treatment no different from a resident company in that country. It means that the national treatment obligation applies if the nationals or residents of the two States are comparably placed or that two persons similarly situated must be treated similarly (Taxmann's Indian Double Taxation Agreements & Tax Laws, Vol. 1, 2004, para 30.3).

[35] Article 25 of the DTAA between India and Sri Lanka also deals with the elimination of tax discrimination in certain precise circumstances and it reads as follows:

> *"ARTICLE 25 - Non-discrimination–*
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> 1. *Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the* ***taxation*** *and*

connected requirements to which nationals of that other State ***in the same circumstances*** *are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.*

2. *The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the* ***taxation*** *levied on enterprises of that other State* ***carrying on the same activities****. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.*
3. *Except where the provisions of paragraph (1) of article 9, paragraph (7) of article 11 or paragraph (6) of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible* ***under the same conditions*** *as if they had been contracted to a resident of the first-mentioned State.*
4. *Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first mentioned State to any* ***taxation*** *or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected.*
5. *The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.*

[36] Article 25 deals with the elimination of tax discrimination that is based on certain grounds or in certain precise circumstances. Article 25 does not seek to ensure most-favoured nation treatment to non-nationals or non-residents, or it does not provide foreign nationals or non-residents with a tax treatment that is **better than that of nationals or resident persons** in enterprises (OECD, Application and Interpretation of Article 24 (non-discrimination) public discussion draft 3 May 2007).

[37] In Johnson And Johnson (Private) Limited v. The Commissioner General of Inland Revenue, CA/TAX/0039/2019 decided on 27.05. 2022, this Court held that;

"This principle in Article 25 requires that similar situations, namely, similar circumstances, carrying on same activities and same conditions shall not

be treated differently or obliges the State to accord the same treatment to a non-resident as that is accorded to its nationals placed in such similar situations (similar circumstances, carrying on similar activities under similar conditions)

[38] In Johnson *And Johnson (Private) Limited v. The Commissioner General of Inland Revenue (supra), this Court further held:*

> *116-This principle requires that the permanent establishments' business activities shall be compared with the similar business activities (same type of business) of the hypothetical resident person, and if both are involved in similar business activities, the non-resident shall not be treated differently or both resident and non-resident shall be treated in the same way (. Secondly, by the application of the ordinary tax laws and regulations, both law and fact, the comparison must be made between the permanent establishment and the hypothetical resident company to ascertain whether they are in the same circumstances. If the domestic tax law/regulations subject a permanent establishment to additional taxation compared to a hypothetical resident placed under the same circumstances in the source country, the non-discrimination provision in Article 25 may be attracted;*
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> *117-Thirdly, the test also requires a comparison to be made between a permanent establishment and a hypothetical resident company with regard to the imposition and exemptions of the tax liability to ascertain whether the two can be placed under the same conditions. If both are placed under the same conditions, a permanent establishment, shall not be treated differently as both hypothetical resident and permanent establishment (non-residents) shall be treated in the same way;*
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> *118-The comparison between the permanent establishment and the hypothetical resident company for the purpose of affording relief from the non-discrimination clause of the DTAA, shall be thus, made subject to the* ***imposition and limitations laid down in the domestic law of the source country subject further, to the extent of inconsistency with Treaty terms.*** *This also means that where the provisions of the domestic tax law are inconsistent with the provisions of the DTAA, the provisions of the DTAA will prevail;*
>
> *119-All what is required is that the provisions of the domestic tax law, shall be interpreted subject to the provisions of the DTAA, otherwise, the domestic tax law would be rendered meaningless and redundant. This is based on the principle that a DTAA exists to avoid double taxation, not to impose taxes as it is not an exercise in tax avoidance but avoidance of double taxation. The DTTA rules merely alter the legal consequences derived from the tax laws of the Contracting States, either by excluding application of the provisions of the domestic tax law where DTAA rules apply or by obliging one or both of the Contracting States to allow a credit against their domestic tax for taxes paid in other States".*

[39] The Appellant who was given the benefit of exempting the interest income earned from Sri Lanka Development Bonds under the provisions of the IRA

2006 cannot claim to deduct the direct interest expenses incurred for the same business of investing in Sri Lanka Development Bonds when there is no material to show that the DTAA provisions are in conflict with the provisions of the IRA 2006. It cannot be said thus, that the provisions of the DTAA override the IRA 2006, or that there is a discrimination in treating the non-resident Appellant comparably placed in similar situations and under the same circumstances in the source country (Sri Lanka) so that the non-discrimination provision in Article 25 may be attracted.

[40] The deductibility or non-deductibility of expenses or outgoings are governed by the provisions of section 25(1) and section 26 of the IRA 2006. The Appellant further relies on the provisions of the IRA 2006 and claims that the interest expenses are deductible under section 25(1)(f) of the IRA 2006 whether it was incurred in the production of income or not and section 26(1)(g) is inapplicable. If so, the Appellant cannot now contend that the provisions of the IRA 2006 are in conflict with the provisions of the DTAA on the deductibility of the interest expenses or that there is a discrimination in treating the Appellant as a non-resident permanent establishment than the resident person of Sri Lanka placed on the same conditions and under same circumstances, both in fact and law, as it applies to a resident.

[41] For those reasons, I am of the view that the deduction of the interest expense claimed by the Appellant is governed by the provisions of the IRA 2006 and not by the provision of Article 7(3) of the DTAA.

Deductibility of interest expense under the provisions of the Inland Revenue Act 2006 (IRA 2006)

[42] Now I shall consider the two arguments of Mr. Ameen that even if it is assumed that the deductibility of interest income is governed by the provisions of the IRA 2006, (i) the interest expenses claimed by the Appellant is an "outgoing" which is not limited to expenditure incurred in the production of profits or income, and therefore, it includes items irrespective of whether or not they are "incurred in the production of profits or income"; and (ii) the interest expenses claimed by the Appellant attract section 25(1)(f) as it is a special rule of deduction despite section 26(1)(g). He first relied on the decision of the Supreme Court in *Hayley and Company Ltd. v. Commissioner of Inland Revenue* (supra).

Deductions allowed in ascertaining profits and income-General Deduction Rule- Section 25 (1)

[43] Income chargeable with income tax is, however, arrived at after taking into account the various exemptions and deductions allowed under the Act and thus, the profits and income or profit or income on which income tax is payable

may be either exempted or deducted by the provisions of the Act. Income tax is calculated by deducting "general" and "specific" expenses from the taxpayer's total assessable income for the assessment year. In *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra), Basnayake C.J., dealing with Section 9 (1) of the Income Tax Ordinance of Ceylon (Cap. 188), which is the corresponding provision of Section 25 (1) of the Inland Revenue Act, No. 10 of 2006, classified the types of deductions for the purpose of Section 9 (1) of the Income Tax Ordinance of Ceylon (Cap. 188).

[44] Basnayake C.J., stated that Section 9 (1) deals with three classes of deductions, (i) "outgoings"; (ii) "expenses" incurred by the assessee in the production of the profits or income and (iii) the "specific deductions" allowed by paragraphs (a) -(i) thereof. The general deductions referred to by Basnayake C.J., in Section 9 (1) are "outgoings and expenses incurred by the assessee in the production of profits and income while the deductions referred to in paragraphs (a) -(i) thereof are the specific deductions.

[45] The body of Section 25 (1) of the Act contains what is known as a general rule of deduction that allows the deduction of "all outgoings and expenses" incurred in the production of profits or income of any person. Section 25 (1) of the Inland Revenue Act (IRA 2006) reads as follows:

> *(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-....***

[46] Section 25 (1) is called a general deduction rule because it deducts all types of "outgoings and expenses" and thus, it prescribes a positive test of deductibility. It provides for what is deductible for the purpose of ascertaining the profits or income of any person from any source. These deductions are allowed only if they fulfil the cumulative criteria of being within the permissive provisions of Section 25 (1) and outside the general prohibitive provisions of Section 26 (1) or 26 (2).

Outgoings and expenses-General deductions

[47] As Section 25 (1) provides that all outgoings and expenses can generally be deducted in terms of the general rule of deduction, firstly, it is important to understand the "outgoings and expenses" referred to in Section 25 (1). In order to be qualified for deduction under Section 25 (1), first, it must have been all "outgoings" and "expenses" incurred in the production of the profits or income.

However, there is a distinction between "outgoings" and "expenses" for the purposes of Section 25 (1) of the IRA 2006.

[48] In the New Shorter Oxford English Dictionary on Historical Principles (Clarendon Press, 1993, Volume 2) at p 2038, "outgoing" is defined to be "expenditure, outlay". The Black's Law Dictionary (West, 9th Ed, 2009) at 658 defines the term "expense" as "an expenditure of money, time, labour, or resources to accomplish a result; especially, a business expenditure chargeable against revenue for a specific period". "Expenditure" in turn is defined by Black's Law Dictionary as "(i). The act or process of paying out; disbursement; (ii). A sum paid out".

[49] The Appellant contended that an interest expense in question need not be incurred in the production of income for it to be deductible under Section 25 (1) of the Inland Revenue Act, relying on the decision in *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra) and *Rodrigo v. The Commissioner-General of Inland Revenue* (supra) that while all expenses are outgoings, all outgoings are not expenses and thus, outgoings are not limited by the words "incurred in the production of the profit or income".

[50] The meaning of "outgoings" was examined by two Sri Lankan cases in *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra) and *Rodrigo v. Commissioner of Inland Revenue* (supra). In this regard, it must be noted that the decision of the Supreme Court in *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra) was followed by Bandaranayake J, (as she then was) in *Rodrigo v. Commissioner of Inland Revenue* (supra). The decision in *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra) that dealt with the general deduction rule in Section 9 (1), specific deduction rule in sub-sections (1) -(i) of Section 9 (1) thereof, and the prohibition of the deduction rule in Section 10 (c) of the Income Tax Ordinance (Chap 188), is instructive.

Hayley and Company Ltd v. Commissioner of Inland Revenue

[51] In *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra), Basnayake C.J., drew a distinction between the word "outgoings" and "expenses" in Section 9 (1) of the Income Tax Ordinance of Ceylon and considered their relationship and limitations. This case considered the question whether the loss suffered by the burglary was an "outgoing" under Section 9 (1) of the Income Tax Ordinance of Ceylon for the purpose of ascertaining the profits or income of the Company from its trade or business. Basnayake, C.J. explained the distinction between the word "outgoings" and "expenses" at p. 175 as follows:

"The word "outgoings" mean what goes out and is a word of wide import. It is the opposite of the equally wide expression "expense", which means what comes in. In the context the word "expense" is limited by the words "incurred by such person in the production thereof, while the word "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. Apart from expenses incurred in the production of profits or income, the section specifically mentions other outgoings. The word "outgoings" in this context, must be construed as outgoings other than those specifically mentioned. ...."

[52] Apart from the outgoings as deductions, a taxpayer can also rely on the expenses incurred in the production of income to be claimed as deductions, which are all outgoings but all outgoings are not expenses incurred in the production of the profits or income. Based on the reasoning of Basnayake, C.J. in *Hayley and Company Ltd v. Commissioner of Inland Revenue* (supra), stated that the term "outgoing" is wider than the term "expense" and while the word "expense" is limited by the words "incurred in the production of the profits or income", the word "outgoing" is not limited by those words.

[53] On the analysis of the facts and circumstances of the case, Basnayake, C.J., held that while the loss suffered by burglary was not an expense incurred in producing the profits of the business, the loss was an outgoing deductible under Section 9 (1) in ascertaining the profits or income. Sinnetamby, J. in the same case, while agreeing that the word "outgoing" is wider than the term "expense", stated that it must not be limited to voluntary payments, but would also include involuntary outgoings such as petty theft by subordinates (p. 177). Sinnetamby, J. stated however, that the "outgoings" must be of such a nature as would come within the meaning of the expression "incurred in the production of profits" (supra). Sinnetamby, J. held that the loss suffered by the assessee must be regarded as incidental to the assessee's business and thus, it was deductible under Section 9 (1) of the Ordinance.

[54] The only disagreement of the views expressed by Basnayake, C.J. and Sinnetamby, J. related to the question whether or not the "outgoings" must be limited by the words "incurred in the production of profits or income". The proposition of Basnayake, C.J. was confirmed by the Supreme Court in *Rodrigo v. Commissioner of Income Tax* (2002) 1 Sri LR 384, where Bandaranayake, J. (as she then was) with Sarath N. Silva, C.J. and Ismail, J. agreeing observed at page 390:

"It is obvious that Section 23 focuses on all aspects of expenses as it refers not only to "expenses", but also to the "outgoings". The word "outgoings"

gives a wider meaning than the word "expense". "Outgoings" incurred by a person carrying out a profession, could include a wide variety of items, which would not come within the meaning of "expenses". Basnayake, C.J. in Hayley and Company Ltd v. Commissioner of Inland Revenue (supra), considered the two phrases referred to above which formed section 9 (1) of the former Income Tax Ordinance. Section 9 (1) is similar to section 23 (1) of our current Act".

[55] This proposition is also consistent with the observations made by the Privy Council in *Patrick Alfred Reynolds v. Commissioner for Income Tax, Trinidad & Tobago* (supra). The Privy Council considered the question whether the conception of "the production of income" used in Section 10 (1) of the Income Tax Ordinance (Law of Trinidad and Tobago, rev., 1950) was appropriate to the specific deduction under Section 10 (1) (f) of the said Act. The Privy Council stated as all the sub-paragraphs in Section 10 (1) (a) -(k) are not directly aimed at what may be broadly called trade, business or profession, and the language of Section 10 (1) (f) is not necessarily related to a business, the conception of the "production of income" is not intended to apply to the specific deduction in Section 10 (1) (f).

[56] The cumulative effect of the views expressed by Basnayake, C.J. and Bandaranayake, J. is that while the word "expenses" is limited by the words "incurred in the production of profits or income", "outgoings" incurred by a person carrying out a profession could include a wide variety of items, which would not come within the meaning of "expenses".

Deductions not allowed in ascertaining profits and income-General Prohibition of Deduction Rule-S.26

[57] Next, I will turn to deductions prohibited in ascertaining profits and income of any person in terms of the provisions of the Inland Revenue Act. While Section 25 (1) refers to general deductions allowed in ascertaining profits or income, Section 26 deals with deductions not allowed in ascertaining profits, and income (general prohibition of deduction). Section 26 of the Act prescribes a negative test of deductibility and prohibits deductions in respect of all outgoings or expenses specified in Section 26 of the Act. This means that even if they fall within Section 25 (1), we will still need to consider whether they would be excluded under Section 26 for the purpose of the general deductibility or general limitations on deductibility.

[58] In order to decide the question whether general deductions permitted under Section 25 (1) are prohibited under Section 26 (1) (g), Sections 25 (1) and 26 (1) have to be read together as both Sections apply to the general deductibility of outgoings or expenses. It was not disputed by the parties at the hearing that

Section 25 (1) and Section 26 must be read together in considering whether or not any outgoing or expense referred to in Section 25 (1) is capable of being deducted as the dispute relates to the deductibility of the interest expenses under sub-sections (f) of Section 25 (1) and limitation of deductions under Section 26 (1) (g) of the Act.

Specific Deduction Formula-Section 25 (1) (a)-(w)

[59] I will now turn to Mr. Ameen's other argument that Section *25* (1) which refers to all outgoings and expenses is the general deduction rule while sub-section (f) of Section 25 (1) contains the specific rule of deduction that was specifically permitted by the legislature. His contention was that Section 25 (1) (f) is a specific deduction rule that specifically allowed deduction of interest expenses incurred for the purposes of the Appellant's business operation whether or not incurred in the production of income and thus, it is not inapplicable by section 26(1)(g).

[60] As noted, *Basnayake* C.J. referring to Section 9 (1) of the Income Tax Ordinance, which is the corresponding provision of Section 25 (1), has clearly stated in *Hayley v. Commissioner of Inland Revenue (supra) that* the deductions allowed by sub-sections (a)-(i) are **specific deductions.** The body of Section 25 (1) contains the general deduction formula that allows the general deduction of "all outgoings and expenses incurred in producing profits or income", which are subject to the general limitations set out in Section 26. In addition to that, the sub-sections (a) to (w) of Section 25 (1) also allow a catalogue of specific deductions in ascertaining profits or income of any person. As noted, Section 25 (1) (f), which allows the deduction of actual expenses incurred by the taxpayer related to interest paid or payable by the taxpayer and section 26(1)(g) disallows deductions not being money expended for the purpose of producing such profits or income.

[61] Now, the question is, if all deductible outgoings and expenses in Section 25 (1) are subject to the limitations set out in Section 26, why did the legislature include several catalogues of other deductions in several sub-sections (a) -(w) of Section 25 (1)? It is inconceivable that the legislature would have included several other specific items of deductions in sub-sections (a) -(w) of Section 25(1), if all the outgoings and expenses are restricted by the general limitation provisions in Section 26 of the Act. In order to determine this question, it is necessary to consider the relationship between Section 25 (1) and Section 25 (1) (f) of the Act.

Is the word "including" in Section 25 of the Act expansive in nature or the same is to be read in a restrictive manner

[62] Mr. Ameen referred to the Privy Council decision in *Patrick Alfred Reynolds v. Commissioner for Income Tax, Trinidad & Tobago* (supra) and argued that the use of the word “including” in Section 25 (1) enlarges the meaning of the words or phrases contained in the statute. He submitted that if the intention was to make the list exhaustive, the legislature would not have used the word “including”' only, but would have used the word “means” or the expression “means and includes” therein.

[63] It is significant to identify the context in which the word “including” has been used by the legislature at the end of the body of Section 25 (1). The interpretation of the term "including" at the end of the body of Section 25 (1) becomes paramount and therefore, one has to understand the true intent of the legislature and put a proper construction to the same. In relation to the meaning to be given to the word "including", the Appellant and the Respondent have cited various definitions and judgments where the word “including” or “includes” or “mean and include” is used in different contexts. For a proper comprehension of the term "including", one should examine the views taken by courts in different jurisdictions.

[64] The word "includes" has different meanings in different contexts. Standard dictionaries assign more than one meaning to the word "include". Webster's Dictionary defines the word "include" as synonymous with "comprise" or "contain". According to Black’s Law Dictionary (West, 4th Ed., 2009) at p. 905, the word “including” may, according to context, express an enlargement and have the meaning of *and* or *in addition to* or merely specify a particular thing already included within general words.

Extensive Construction

[65] It is well-settled that when the interpretation clause used an inclusive definition, it would be generally expansive in nature and thus, it seeks to enlarge the meaning of the words or phrases used in an interpretation clause, unless it manifests a contrary intention very clearly (P. M. Bakshi, Interpretation of Statutes, First Edition, 2008, pp. 242-243). In such case, the word “include” must be construed as comprehending, not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include (*Commissioner of Inland Tax v. Banddarawathie Fernando Charitable Trusts* (63 N.L.R 409). Generally, when the word "include" is used in a definition clause, it is used as a word of enlargement, and in that sense, the term “include” would suggest definition to be extensive and not restrictive.

Exhaustive Construction- “means and includes”

[66] Moreover, the words “means and includes” indicate an exhaustive explanation of the meaning which, for the purposes of the interpretation of a statute, must invariably be attached to these words or expressions. The use of the words, “means and includes” would, therefore, suggest that the definition is intended to be exhaustive and not extensive (*P. Kasilingam v. P.S.G. College of Technology*, AIR 1995 SC 1395, p. 1400). *Lord Watson in Dilworth v. Commissioner of Stamps,* [1899] A.C. 99, (P.C.) stated that it is susceptible of another construction, which may be imperative if the concept of the Act is sufficient to show that it was not merely employed for the purpose of adding to the natural words used are defined. He stated at pp. 105-106:

> *“But the word "include” is susceptible of another construction, which may become imperative, if the context of the Act is sufficient to show that it was not merely employed for the purpose of adding to the natural significance of the words or expressions defined. It may be equivalent to "mean and include,” and in that case it may afford an exhaustive explanation of the meaning which, for the purposes of the Act, must invariably be attached to these words or expressions”*

[67] In that sense, the term “include” would suggest definition to be exhaustive and not extensive (*Reliance Industries Ltd, Bombay v State of Maharashtra* AIR 2006 Bom 213). Thus, the word “include” may, where the context so demands, be equivalent to “mean and include”, in which case the definition, though apparently inclusive, is to be taken as exhaustive *(Dilworth v. Commissioner of Stamps).*

Enumerative construction-includes

[68] Under the third category of construction, the function of the word “includes” is merely enumerative and brings under one nomenclature all transactions possessing certain similar features, but going under different names (*Reserve Bank of India v. Peerless General Finance and Investment Co. Ltd,* AIR 1987 SC 1023 p. 1041. This construction was adopted by Thambiah J. in *Commissioner of Inland Revenue v. Cross Raj Chandra* 67 N.L.R. 174 at p. 179) as the third category of the function of the word “includes”. In such cases, Thambiah, J. explained that the term is placed preceding the word “includes”, and is followed by a number of other terms which, in common parlance, may not connote the term which precedes the word “includes” (supra).

[69] As Tambiah J. explained, the word “business” is defined as “Business includes agricultural undertakings”, but in common parlance, agricultural undertakings will not be construed as business (supra). In this situation, the setting, context and object of an enactment may provide sufficient guidance for interpretation of the word “includes” or “including” for the purposes of such

enactment. Tambiah, J. after an exhaustive analysis of cases, recognized these three categories of the function of the word "includes" in *Commissioner of Inland Revenue v. Cross Raj Chandra* (supra), and stated at pp. 178-179) that:

1. The word "includes" is generally used in interpretative clauses in order to enlarge the meaning of words or phrases occurring in the body of the statute and when so used these words or phrases must be construed as comprehending, not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include;

2. But, the word "includes" is susceptible of another construction, which may become imperative, if the context of the Act is sufficient to show that it was not merely employed for the purpose of adding to the natural significance of the words or expressions defined. It may be then, equivalent to mean and include and, in that case, it may afford an exhaustive explanation of the meaning which, for the purposes of the Act, must invariably be attached to these words or expressions;

3. Under the third category, the word "includes" is merely enumerative and in such cases, the term is placed preceding the word "includes" and is followed by a number of other terms which, in common parlance, may not connote the term which precedes the word "includes".

[70] From the above decisions, it can be said that the word "includes" or "including" can have the following functions in a statute:

1. The word "includes" or "including" is normally used in any statute to enlarge the scope of the definition or expression to include things that would not properly fall within its ordinary connotation. In other words, it is used as an extensive word;

2. If the context of the Act, it is sufficient to show that it was not merely employed for the purpose of adding to the natural significance of the words or expressions defined, it can be also used to give an exhaustive or restrictive meaning and, in that case, it may be used as equivalent to "means" and also "means and includes";

3. The setting, context and object of an enactment, may provide sufficient guidance for interpretation of the word "includes" for the purpose of such enactment bringing under one nomenclature all transactions possessing certain similar features but going under different names.

The Principle of Construction in *Patrick Reynolds v. Income Tax Commissioner for Trinidad and Tobago*

[71] Now, we will turn to *Patrick Alfred Reynolds v. Commissioner for Income Tax, Trinidad & Tobago* (supra), which on a similar structure of another Income Tax Ordinance (Income Tax Ordinance (Laws of Trinidad and Tobago 1950) proceeded to construe the word "including" and relationship between the general deduction, prohibition of deduction and the specific deduction rules in ascertaining the profits or income of a taxpayer.

[72] In the said case, both the Appellant and his wife (Mrs. Reynolds) had at all material times been living together and had been in receipt of income from earnings and investment. Mrs. Reynolds entered into a deed of covenant under which she undertook to make annual payments to a trustee for the benefit of the four children of the marriage. The Appellant's return of income for the relevant year of assessment showed a total income received in the preceding year of $ 40,164.86 of which $ 18,202 represented Mrs. Reynolds' income. The Appellant claimed that the aggregate sum of $ 14,000 paid by Mrs. Reynolds under the deed of covenant should be deducted from her income in computing the Appellant's chargeable income.

[73] The main issues *inter alia*, that arose for the determination in the said cases were as follows:

1. Whether Section 10 (1), on its true construction, and having regard to the word "including" was a word of extension?
2. If so, whether it was intended to embrace the deductions specified in sub-paragraphs (a) to (k) of Section 10(1), in addition to all legitimate deductions of expenses incurred in the production of income;
3. If so, whether the prohibition of deduction in Section 12 (1) (b) negatived the provisions of Section 10 (1(f);
4. Whether annual payments under a deed of covenant were deductible from assessment of the husband's income; and
5. Whether the wife was the "disponer" within Section 34 (2) of the Income Tax Ordinance of Trinidad and Tobago.

[74] The Privy Council considered the issue whether the general limitation in Section 12 (1) (f), which prohibited the general deduction under Section 10 (1), intended to take away the specific deduction that has been expressly provided under Section 10 (1) (f) of the Income Tax Ordinance (Laws of Trinidad and Tobago). Section 10 (1) of the Income Tax Ordinance (Laws of Trinidad and

Tobago) contains a similar structure to Section 25 (1) of the IRA 2006 and at the end of the body of the said Section, refers to the word “including” as follows:

> *“10 (1) -For the purpose of ascertaining the chargeable income of any person, there shall be deducted all outgoings and expenses wholly and exclusively incurred during the year preceding the year of assessment by such person in the production of the income, **including**.......”* [Emphasis added]

[75] Then, there are sub-paragraphs (a) to (k) of Section 10 (1) which sets out examples of permissible deductions and sub-paragraph (f) of Section 10 (1) allowed annuities to be deducted. It reads:

> *“10 (1) (F) - **annuities or other annual payments,** whether payable within or out of the Colony, either as a charge on any property of the person paying the same by virtue of any deed or will or otherwise, or as a reservation thereout, or as a personal debt or obligation by virtue of any contract: Provided that no voluntary allowances or payment of any description shall be deducted”.*

[76] On the other hand, Section 12 (1) deals with the prohibition of deduction rule and disallowed disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring income. It reads as follows:

> *“For the purpose of ascertaining the chargeable income of any person, no deduction shall be allowed in respect of (a) domestic or private expenses; (b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring the income.... f) rent of or cost of repairs to any premises or part of premises not paid or incurred for the purpose of acquiring the income...”*

[77] The Privy Council considered the most important question whether the use of the word “including” at the end of the body of Section 10 (1) would be expansive or restrictive in nature in the context of the prohibition of deduction under Section 12 (1) (b). The Privy Council referred to the following observations made by *Lord Watson* in *Dilworth v. Commissioner of Stamps,* (supra) at pp. 105-106, and stated that the word “include” is generally used in a statute, to enlarge the meaning of words or phrases in a statute, and that it enumerates categories of classes which will not be included in the concept of the term which precedes. It reads:

> *"The word 'includes' is very generally used in interpretation clauses to enlarge the meaning of words or phrases occurring in the body of the statute; and when it is so used these words or phrases must be construed*

> *as comprehending not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include".*

[78] Having analysed the decision in *Dilworth v. Commissioner of Stamps,* (supra)*,* the Privy Council stated at p. 11 that:

1. Section 10 (1), on its true construction, and having regard to the word "including" which was a word of extension, was intended to embrace the deductions specified in sub-paragraphs (a) to (k), in addition to all legitimate deductions of expenses incurred in the production of income;

2. Section 12 (1) (b) which was of limited application, did not negative or fetter the provisions of Section 10 (1) (f) of the Income Tax Ordinance (Laws of Trinidad and Tobago).

[79] Lord Hodson stated at p. 11:

> *"In looking at this section as a whole, including all its sub-paragraphs, their Lordships have already noticed that not all of the sub-paragraphs appear to be directly aimed at what may broadly be called trade, business of profession and they are of the opinion that the language of sub-paragraph (f), in particular the reference to a "will" points to the conclusion that (f) is looking at something which is not necessarily a business and that the conception of "the production of the income" is inappropriate and certainly not necessary to be regarded as a provision which governs this subparagraph. Their Lordships, therefore reading the word "including" broadly have reached the same conclusion as Blagden J. at first instance, following the decision of Gilchrist J. in an earlier case of an appeal in Trinidad by one Joseph Galvan Kelshall (No. 443 of 1939). This construction as Gilchrist J. pointed out is supported by the fact that in sub-paragraph (f) there are no limiting words referring specifically to the acquiring of income, such as appear in sub-paragraphs (a), (b) and (h) of the same section. Further, this construction is not inconsistent with section 12 which read together with section 10, is of limited application and does not take away that which has been expressly provided by section 10(1)(f) ".*

[80] The decision in *Reynolds v. Income Tax Commissioner for Trinidad and Tobago* (supra) established the following propositions in the interpretation of the functions of the word "including" in a similarly structured Act that:

1. The use of the word "including" in Section 10 (1) was a word of extension and intended to embrace the deductions specified in sub-paragraphs (a*)* to (k*) of Section 10 (1),* in addition to all legitimate deductions of expenses expressly provided by Section 10 (1) (f);

2. The word "Including" is generally used to enlarge the meaning of the preceding word.

[81] The courts in interpreting the word “includes” or “including” are not adopting any uniform rule and thus, sometimes, the word “includes” may be extensive or sometimes exhaustive. But whether the meaning of the *word **“including”*** is extensive in nature (a phrase of extension) or exhaustive in nature (a phrase of restriction), depends on the **setting, context and the object** in which it is used in any statute in its entirety and the **purpose** of the statute intended by the legislature. Depending on that, the word "including" may be intended to clarify or explain or restrict the definition in an exhaustive manner, or add or extend the definition in an extensive manner.

Are specific deductions expressly provided in a statute limited or restricted by the general deduction provisions?

[82] Now, the question is whether the specific deductions expressly provided in a statute are limited or restricted or disqualified by the general deduction provisions in a statute. The decision in *Reynolds v. Income Tax Commissioner for Trinidad and Tobago* (supra), also recognised the general rule of construction that general provisions yield to special provisions when the Privy Council stated that the general deduction provisions in Section 10 (1) read with the prohibition of deduction in Section 12 (1) (b) did not negative or fetter or take away the deduction which has been expressly provided by Section 10 (1) (f).

[83] It is not disputed, however, that Section 10 (1) of the Income Tax Ordinance of Trinidad and Tobago, 1950 is identical to the corresponding Section 25 (1) of the IRA 2006 of Sri Lanka, which specifies the general deduction rule. The Privy Council however dismissed the appeal on different grounds. The Privy Council was of the view that the payments to the trust for the maintenance and benefits of a taxpayer’s child are within the prohibition of Section 12 (1) (b) which prohibits any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring the income.

[84] The principle emanating from this analysis is that while the general deduction rule is restricted by the prohibition of deduction rule, any deduction provision which has been **expressly provided by any statute** is not taken away by the general prohibition of deduction. In my view, the above principle in Patrick *Alfred Reynolds v. Commissioner for Income Tax, Trinidad & Tobago* (supra) is relevant and applies in interpreting similarly structured general deduction rule in Section 25 (1) and the prohibition of deduction in Section 26 when a specific deduction formula has been expressly provided by a tax statute,

unless the effect of such specific provision has been limited by the words provisions of the same statute indicating any contrary legislative intention in the Act.

General and Specific Deduction Formula in the same Statute

[85] Now the question is, if an item of expenditure passed the general positive test in Section 25 (1) and the specific deduction formula in Section 25 (1) (f), could the legislature have intended that the specific deduction provision in Section 25 (1) (f) would still be disqualified under a general prohibition of deduction in Section 26 (1) (g). In other words, the question is whether the deduction allowed by Section 25 (1 (f) is prohibited by the words in Section 26 (1) (g) and therefore, the expenses claimed by the Appellant are not permissible expenses to be deducted by the application of section 26(1)(g).

[86] In *Rodrigo v. Commissioner General of Inland Revenue* (supra), the Court held that any disbursement or expense which was not spent for the purpose of production of profits or income cannot be deducted, and if any part of the expenses could be clearly identified as having being expended for the purpose of deriving money not being profits or income liable to tax, such amount could not be deducted in terms of section 24(1)(g) (p. 394).

[87] Section 23 (1) of the Inland Revenue Act, No. 28 of 1979, similar to Section 25 (1) of the Inland Revenue Act, No. 10 of 2006 was in the following terms:

> *"....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.****....."*

[88] Section 24 (1) (g) of the Inland Revenue Act, No. 28 of 1979, was in the following terms:

> *"For the purpose of ascertaining the profits or income of any person from any source 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 and income."*

[89] The words in Section 23 (1) are restricted by the words given in Section 24 (1) (g) of the Act, No. 28 of 1979 are consistent with the scheme of Section 25 (1) of the Inland Revenue Act, No. 10 of 2006, which is the general deduction provision and Section 26 of the Inland Revenue Act, No. 10 of 2006, is the general prohibition of deduction.

[90] Mr. Ameen relied on the decision the Privy Council in *Reynolds v. Commissioner of Income Tax Trinidad, Tobago* (supra) and *Rodrigo v.*

Commissioner of Inland Revenue (supra) to support his argument that the expenditure which is specifically provided in section 25(1)(f) is deductible, whether interest paid or payable and whether such expenditure has been incurred in the production of income or not. In *Rodrigo v. Commissioner-General of Inland Revenue* (supra), Bandaranayeke, J. (As she then was), in interpreting the provisions of Sections 23 (1) and 24 (1) (g) of the Inland Revenue Act, No. 28 of 1979, which are identical to Section 25 (1) and 26 (1) (g) of the Inland Revenue Act, No. 10 of 2006, was of the view that:

> *"Sections 23 (1) and 24 of the Act have to be read together as both provisions apply to the deductibility from the income. While section 23 spells out the permissible expenses, section 24 expressly disallows the whole of part of certain expenses, which if not so prohibited, would be allowable. The combined effect of sections 23 and 24 therefore is to divide all outgoings and expenses into two categories: outgoing expenses which are deductible and not deductible".*

[91] In order to be qualified for a general deduction under Section 25 (1), outgoings or expenses must have fulfilled the requirements of Section 25 (1), (which depends on the circumstances of each case), read with the prohibitions set out in Section 26 of the Act. In other words, when they qualify both under Sections 25 (1) and 26, they are allowable deductions in ascertaining the profits and income of any person.

[92] The prohibition of deductions (negative limb) in Section 26 (1) may relate to outgoings or expenses and in these proceedings, Section 26 (1) (g) is pertinent and it reads:

> *"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 disbursement or expenses of such person, not being money expended for the purpose of producing such profits or income."*

[93] The effect of Section 25 (1) read with Section 26(1)(g) is that it permits deductions of all outgoings and expenses which satisfy the following characteristics under Section 25 (1):

(i) deductions must have been either outgoings or expenses; and

(ii) (a) they must be outgoings incurred in the carrying out a trade, business, profession or vocation, which could include, a wide variety of items, which would not come within the meaning of "expenses"; or

(b) they must be expenses incurred in the production of the profits or income; and

(iii) they must be not deductions prohibited under Section 26 in ascertaining profits, and income (excluded deductions from the general deduction in Section 25 (1).

[94] The Supreme Court in *Rodrigo v. Commissioner-General of Inland Revenue* (supra), observed that Section 24 (1) (g) read with Section 23 (1) of the Act, show that-

(a) all outgoings and expenses incurred by a person in the production of income from any source could be incurred as deductions-Section 23(1);
(b) any disbursement or expenses which was not spent for the purpose of production of profits and income cannot be deducted as specified in Section 24(1)(g).

[95] Having identified the combined effect of the two sections, the Supreme Court held that (i) the general deduction provision in Section 23 (1) is restricted by the general prohibition provision in Section 24 (1) (g); and (ii) although all outgoings and expenses incurred are deducted under Section 23 (1), any amount which was not expended for the purpose of producing the income cannot be deducted (p. 395).

[96] It is crystal clear that the Supreme Court in *Rodrigo v. Commissioner General of Inland Revenue* (supra), only considered the combined effect of the two general provisions, namely, the general deduction provision-positive rule, and the general prohibition of deduction-negative rule. It held that the general deduction provision in Section 25 (1) (positive rule) is restricted by the general prohibition of deduction provision in Section 26 (negative rule). This principle that Sections 25 (1) and 26 should be read together on the basis of the judgment in *Rodrigo v. Commissioner General of Inland Revenue* (supra) is consistent with the position taken by the Appellant in the present case, and in my view, it is the correct interpretation of the said two provisions. This principle, however, did not prevent the Tax Appeals Commission from considering the distinction between the specific deduction in Section 25 (1) (k) and the prohibition of deduction in Section 26 (2).

[97] However, the Supreme Court *in Rodrigo v. Commissioner General of Inland Revenue* (supra) was not invited to consider the interpretation of the Privy Council decision in *Patrick Alfred Reynolds v. Commissioner for Income Tax, Trinidad & Tobago* (supra) or the relationship between any **specific deduction** provision such as Section 25 (1) (f) and the **general prohibition on deduction** provision such as Section 26 (1) in the present case.

[98] Both Courts in *Rodrigo v. Commissioner General of Inland Revenue* (supra) and *CEI Plastic Limited v. Commissioner* of Income Tax (C.A/Tax/03/2013 decided on 01.02.2019) were not called upon to interpret the structure of the general deduction rule, the prohibition of deduction rule and the specific deduction rule. In the present case, however, the Tax Appeals Commission was specifically invited to consider whether Section 25 (1) (f) is a specific deduction provision and if so, its relationship and effect with Section 26 (1). In other words, this Court is invited to consider, having regard to the facts of the case whether the general deduction rule is intended to interfere with the special deduction provision unless it manifests any other legislative intent very clearly.

[99] The scheme of the Act clearly suggests that the word "including" in Section 25 (1) was intended by the legislature to extend to the specific deduction in Section 25 (1) (f), in addition to all legitimate deductions of expenses incurred in the production of income. But the general prohibition of deduction in Section 26 (1) (g) does not neutralise or negate the specific deduction provision in section 25(1)(f) unless a contrary intention is indicated very clearly in the language of section 25(1)(f) or section 26 (1) (g).

[100] Having reproduced the observations made by Basnayake, C.J in *Rodrigo v. Commissioner of Income Tax (*supra) and referring to attendant expenses other than expenses incurred in the production of income, Bandaranayake, J. stated at p. 300 of the judgment:

> *"On the other hand, in addition to the outgoings a taxpayer would also rely on the expenses that incurred in the production of the income to be claimed as deductions. The meaning of the phrase "incurred in the production of the income was considered in the South African case of Port Elizabeth Electric Tramway Company Ltd v. CIR (1936) CPD 241, 8 S.A.T.C. 13) where, Watermeyer, AJP was of the view that-*
>
> *".. 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…..*
>
> *The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation, provided they are so closely connected with it that they may be regarded as part of the cost of performing it".*

[101] Section 25 (1) (f), specifically deducts interest paid or payable by a taxpayer without any limitation and thus, the language of section 25(1(f) may extend to include "outgoings not necessarily incurred in the production of profits or income" as no restriction is placed in that section or in section 26(1). Hence, the concept of "the production of the profits or income" in sections 25(1) and 26(1)(g) is not to be regarded as governing section 25(1)(f), which includes outgoings not necessarily incurred in the production of income.

[102] Now the only question is whether the expenses claimed by the Appellant can be said to be only "outgoings" not necessarily incurred in the production of profits or income such as all expenses attached to the performance of business operation bona fide performed for the purpose of earning income. The Appellant must identify the claim expenses and include them in its statement of accounts and show clearly that the claimed interest expenses were not expenses really incurred in the production of profits or income but expenses incurred for the efficient performance of its business operation in relation to Sri Lanka development bonds.

[103] Mr. Balapatabendi submitted that as the Appellant had got the benefit of the exemption for interest income under section 13(xxx) of the IRA 2006, the Appellant is not entitled to the advantage of deducting the interest expenses earned in respect of the same 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 without identifying the expenses claimed separately in the statement of accounts. Mr. Balapatabendi 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.

[104] 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 bank 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 the dual benefit of the exemption from interest income and the deduction of borrowing costs and that it can only deduct the expenses incurred to generate the taxable income.

[105] Dehideniya J. first, took into consideration of 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 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].

[106] The third point addressed by Dehideniya J. was that the bank 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. He stated:

> *"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…".

[107] 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 the production of taxable income under the provisions of the IRA 2006 where he has not really incurred that expense to produce or generate the taxable income and that he has not identified its expenses separately under section 106(11) of the IRA 2006.

[108] The question with regard to the deduction of expenses under the section 25(1)(f) is this: Is the taxpayer who got the benefit of an exemption under section 13(xxx) entitled to deduct the expenses claimed by it where it has truly and really incurred such expenses in the performance of business in relation to the Sri Lanka Development Bonds and identified such expenses separately in his accounts.

[109] In *P.D. Rodrigo v. CGIR* (supra), 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, that 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 earning the non-taxable profits.

[110] 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".

[111] In my view, the proper test is to consider whether or not the expenses were really incurred in the performance of the operation of the business, as outgoings not necessarily being incurred in the production of profits or income in relation to Sri Lanka Development Bonds, and if so, whether they have been separately identified in the statements of accounts. Where the interest expenses are truly and really linked to the business operation of the Appellant and identified them 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.

[112] However, where the taxpayer who got its interest income exempted from tax, under section 13(xxx), fails to show that it truly and really incurred expenses as outgoings to perform the operation of its business and identify them separately in the accounts, he cannot have a dual benefit from both the tax interest exemption and deduction of interest expenses. If it is allowed, the taxpayer will get dual benefit from the investment and an additional advantage of deducting the expenses not incurred and linked to its business operation as an outgoing, though not necessarily being incurred in the production of income.

Has the Appellant really incurred expenses in the performance of its business operation?

[113] Now the crucial point is whether or not the Appellant has satisfied that truly and really incurred expenses as outgoings in the carrying on or performance of its business operations in relation to Sri Lanka Government Bonds, and identified them separately in the accounts. The assessor has stated in his letter dated 22.11.2013 that (i) the expenditure incurred in the production of such interest income and the expenses claimed should be clearly identified separately; (ii) the Appellant has failed to identify the expenses incurred in the production of exempt interest in relation to Sri Lanka Government Development Bonds. He allowed the interest income claimed by the Appellant under section 13(xxx) but disallowed the deduction of interest expenses, said to have been incurred from investment in Sri Lanka Development bonds.

[114] The assessor has calculated the expenses on a pro rate basis since it was not possible for him separately identify the interest expenses claimed by the Appellant as follows:

$$\text{Disallowable Direct Expenses} = \frac{\text{(Interest Income from SLD)}}{\text{(Total Interest Income of Bank)}} \times \text{(Total Interest Expenses)}$$

$$\text{Disallowable Direct Expenses} = \frac{(63{,}449{,}772)}{(493{,}623{,}587)} \times (171{,}924{,}313)$$

$$= \underline{\underline{22{,}098{,}941/=}}$$

[115] A perusal of the TAC brief reveals that the Appellant has not produced the statement of accounts before the TAC and identified the claimed outgoings incurred in the performance of its business operation and maintained separate accounts for interest income and interest expenses separately as required by section 106 (11) of the IRA 2006. No submission was made during the course of the argument that the Appellant had maintained separate accounts and identified the outgoings incurred for the purpose of the business of the Appellant in relation to Sri Lanka development Bonds.

[116] Unlike in the case of *P.D. Rodrigo v. CGIR* (supra), the issue in the present case is about the deductibility of interest expenses incurred either in the production of interest income or outgoings, not being incurred in the production of profits and income. In any event, in the case of 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

[117] The Appellant who claims that the expenses claimed do not relate to the production of profits or income but outgoings must maintain separate accounts and identify such expenses separately in the statement of accounts. No material had been produced by the Appellant to identify the nature of expenses, whether incurred in the production of profits or income, or outgoings incurred in the performance of business operation by the Appellant in the performance of its business generating non-taxable exempt income, which has not been separately identified by the Appellant in its audited statement of accounts.

[118] In my view, the Appellant has failed to identify the nature of the expenses claimed by it and show that it has actually incurred expenses in the performance of its business operation in relation to Sri Lanka Development Bonds and include them separately in the audited statement of accounts. For those reasons, I hold that the Appellant is not entitled to deduct the interest expenses claimed by it under the provisions of section 25(1) (f) of the IRA 2006.

Tax Credit

[119] The assessor has not separately allowed the tax credit amount of Rs. 15,945,648/- in terms of section 136 of the IRA 2006 and the Commissioner in his written submissions has stated that the Appellant is entitled to claim the said tax credits for the year of assessment 2010/2011 (pp 98-99 of the TAC brief). The Commissioner has however stated that:

> *"When made the assessment, the Assessor has not allowed withholding tax and notional tax credit amount of Rs. 15,945,648 as tax credit/* ***However, same amount has been deducted from the profits from trade or business as expenses when arrived at the total statutory income"***

[120] In calculating the total statutory income, the assessor has deducted withholding tax credit in a sum of Rs. 15,945,678 as shown in his tax calculation (p. 53 of the TAC file) as follows:

	Rs.
Total Statutory Income as declared	145,658,769
Add: Disallowable Direct Cost on SLDB Income	22,098,941
	167,757,710
Less: With Holding Tax deducted	(15,945,678)
Adjusted Total Statutory Income	**151,812,032**
Less: Deduction under Section 32	-
Adjusted Assessable Income	**151,812,032**
Less: Deduction under Section 33	-
Adjusted Taxable Income	**151,812,032**

Income Tax Liability for the Y/A 2010/2011

Tax on Taxable Income	151,812,032/-@ 35%	53,134,211/-
Tax on Interest Income to Head Office	48,063,982/-@10%	4, 806,398/-
SRL Liability	57,940,609/-@1.5%	869,109/-
Total Tax Liability		58,809,718/-
Less:		
ESC paid		4,933,536/-
Self-Assessment Payments		23,901,685/-
SRL Paid		671,713/-
Total Tax Credit		(29,506,934)
Balance Tax Payable		29,302,784/-

[121] The Commissioner too has deducted the said withholding tax credit of Rs. 15,945,678 in his calculation (p. 25 of the TAC brief) as follows:

Declared adjusted profit for the year			145,658,769
Add			
Disallowed direct cost on SLDB income			22,098,941
Adjusted taxable Income			167,757,710
Tax on taxable Income	35%	167,757,710	58,715,199
Tax on Interest income to Head Office	10%	48,063,982	4,806,398
SRL Liability	1.5%	63,521,597	952,824
Total Tax Liability			64,474,421
Tax Credits			
ESC Paid			4,933,536
Self-Assessment payments			23,901,685
SRL Paid			671,713
WHT			15,945,678
Total Tax Credits			45,452,612
Balance Tax Payable			**19,021,809**
Penalty			**9,510,904**
Total Payable			**28,532,713**

[122] It is crystal clear that the said amount of tax credit in any event has been deducted from the Appellant's total statutory income by the assessor and therefore, the same has been deducted from the profits of the business of the Appellant as expenses when arriving at the total statutory income of the Appellant. For those reasons, the TAC has correctly held that at the end, the bank has been allowed to claim the said tax credit for the year of assessment 2010/2011. The findings of the TAC at page 23 of the brief are as follows:

> *"Further, the issue was raised by the Representative for the Appellant that the Appellant was not granted credit in respect of the withholding tax recovered. On this matter, the Representative for the Respondent submitted that, when the assessment was made, the Assessor has not allowed the withholding tax and the notional tax credit amounting to Rs. 15,945,678/= as tax credits. However, the same amount has been deducted from the profits of the business as expenses, when arriving at the*

total statutory income. Therefore, the Appellant Bank has been allowed to claim the said tax credit for the year of assessment 2010-2011."

[123] The Appellant claims that the TAC failed to make available to the Appellant, the written communication of the IRD made after the re-hearing of the case on 24.01.2019 in relation to the issue of allowability of the credits for tax withheld on interest income. The Commissioner filed written submissions on 25.01.2019 (p. 24 of the TAC brief) and the determination was made by the TAC on 05.02.2019 (p 23 of the TAC brief). No complaint had been made by the Appellant before the TAC that the Commissioner had not made available the said written submissions to the Appellant. In any event, the Appellant filed comprehensive written submissions before the argument commenced before us, and we heard Mr. Ameen on the contents of the said written submissions during the course of the argument arising from the said written submissions. I am of the view that there is no merit in the argument raised by the Appellant that the TAC has violated the rules of natural justice by not giving an opportunity to reply to the said written submissions.

[124] For those reasons, I see no reason to interfere with the said finding of the TAC in respect of the tax credit claim raised by the Appellant.

Conclusion

[125] For those reasons, I answer questions of law arising in the case stated in favour of the Respondent and against the Appellant as follows:

1. No
2. No
3. No
4. The decision of the Privy Council in *Patrick Alfred Reynolds v. Commissioner of Income Tax, Trinidad & Tobago* is relevant for the determination of the general rule of deduction, prohibition of deduction and the special rule of deduction. However, the Appellant has failed to identify the nature of the expenses claimed by the Appellant as "outgoings" in its statement of accounts and include them in the accounts separately as required by section 106(11) of the IRA 2006;
5. Not proved
6. No. The said amount of Rs. 15,945,678/- has been deducted as expenses from the total statutory income of the Appellant and thus, the Appellant has been allowed to deduct the same for the year of assessment 2010/2011.

7. No.

[126] For those reasons, the determination made by the Tax Appeals Commission dated 05.02.2019 is affirmed and 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