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

The Wheel Works (Pvt) Ltd,
No.68, Block A, Biyagama
Export Processing Zone,
Biyagama.

Appellant

CA TAX No. 11/2013

Tax Appeals Commission

Appeal No. TAC/IT/004/2011

Vs.

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

Respondent

Before: Hon. D.N. Samarakoon, J.

Hon. Sasi Mahendran, J.

Counsel: Mr. Riad Ameen instructed by D. L. and F. de Saram for the Appellant.

Mr. Manohara Jayasinghe, D. S. G., for the Respondent.

Argued on: 03.08.2021

Written submission tendered on: 27.08.2019 by the Appellant.

30.08.2016 and 15.03.2022 by the Respondent.

Decided on: 08.08.2023

D.N. Samarakoon, J

(01) Introduction:-

It is said,

> "The larger the depreciation expense, the lower the taxable income, and the lower a company's tax bill. The smaller the depreciation expense, the higher the taxable income and the higher the tax payments owed[1]" – Investopedia

This is also the common sense.

It is stated, in Written Submissions of the Appellant, The Wheel Works (Pvt) Ltd., dated 27.08.2019, at paragraph 14 that,

> "Profits and income arising from sale of capital assets is a capital gain and therefore it is not normally liable for income tax unless express provision is made for it".

Mr. E. Gooneratne, says at page 163 – 164 of his book **Income Tax in Sri Lanka, First Edition, 1991**,

> "Depreciation is a loss of capital. Where an allowance for depreciation has been granted in respect of a capital asset used in a trade or business the total of the allowances granted in previous years must be brought into

[1] What Is the Tax Impact of Calculating Depreciation? (investopedia.com)

the computation of a capital gain arising on the disposal of such asset. (a) **When the total of the allowances granted for depreciation is equal to the cost of acquisition there is no loss.** The whole of the proceeds of disposal is profit or gain. Part of the proceeds of disposal not in excess of the cost of acquisition is taxed as profit of the trade or business. (b) **The difference between the proceeds of sale and the cost of acquisition is taxable as capital gain**. (c)***When the total allowance for depreciation is less than the cost of acquisition the profit is reduced by an amount equal to the difference between the cost of acquisition and total allowance for depreciation***. (d)The proceeds of disposal not in excess of the cost of acquisition less the difference between the cost of acquisition and total allowance for depreciation is taxed as profits of the trade or business. (e)**The difference between the proceeds of disposal and the cost of acquisition is taxable as capital gain**. The provisions are applicable to capital assets acquired and also capital assets constructed used in a trade or business for which an allowance for depreciation has been granted. (f)**When the total allowance for depreciation is less than the cost of acquisition or cost of construction the owner is indemnified for the loss of capital by the deduction of the difference from the proceeds of disposal**. No deduction shall be made in respect of any capital loss arising from the disposal of any capital assets used in producing profits and income in any trade, business, profession or vocation if a deduction for depreciation has been allowed in respect of such asset under section 23".

This Court is not considering the above passage as absolute truth, because the provisions of the applicable Inland Revenue Act govern the question. But it can assist the Court to clarify the position. The situation in (a) is as follows,

(a) **When the total of the allowances granted for depreciation is equal to the cost of acquisition there is no loss.** The whole of the proceeds of disposal

is profit or gain. Part of the proceeds of disposal not in excess of the cost of acquisition is taxed as profit of the trade or business.

Cost is Rs. 1,000,000/-

Depreciation Allowance is Rs. 1,000,000/-

The whole of the proceeds of disposal is profit or gain.

Part of the proceeds of disposal not in excess of the cost of acquisition is taxed as profit.

Hence, if proceeds are Rs. 500,000/-, as it is not in excess of the Cost, it is taxed.

The situation in (b) is as follows,

(b) **The difference between the proceeds of sale and the cost of acquisition is taxable as capital gain**.

Proceeds of disposal is Rs. 1,500,000/-

Cost is Rs. 1,000,000/-

Difference Rs. 500,000/- taxable as capital gain.

The situation in (c) is as follows,

(c) ***When the total allowance for depreciation is less than the cost of acquisition the profit is reduced by an amount equal to the difference between the cost of acquisition and total allowance for depreciation***.

Cost is Rs. 1,000,000/-

Depreciation Allowance Rs. 500,000/-

Rs. 500,000/- is reduced from profit.

The situation in (d) is as follows,

(d)The proceeds of disposal not in excess of the cost of acquisition less the difference between the cost of acquisition and total allowance for depreciation is taxed as profits of the trade or business.

Cost is Rs. 1,000,000/-

Proceeds of Disposal Rs. 700,000/- less

Cost is Rs. 1,000,000/-

Depreciation Allowance Rs. 400,000/-

Difference Rs. 600,000/-

Rs. 700,000/- - Rs. 600,000/- = Rs. 100,000/- taxed as profit.

The situation in (e) is as follows,

(e)**The difference between the proceeds of disposal and the cost of acquisition is taxable as capital gain**.

Proceeds of Disposal Rs. 1,500,000/-

Cost is Rs. 1,000,000/-

Difference Rs. 500,000/- taxed as capital gain. This is same as in (b) above.

The situation in (f) is as follows,

(f)**When the total allowance for depreciation is less than the cost of acquisition or cost of construction the owner is indemnified for the loss of capital by the deduction of the difference from the proceeds of disposal**.

Cost is Rs. 1,000,000/-

Depreciation Allowance Rs. 300,000/-

Proceeds of Disposal Rs. 700,000/-

Difference Rs. 700,000/- - Rs. 700,000/- = Rs. 0/-

Section 25 of Inland Revenue Act comes under the section "**ASCERTAINMENT OF PROFITS OR INCOME**".

Section 25(3)(a) says,

> "(3) (a) Where any person disposes of any capital asset used by him in producing the profits and income of any trade, business, profession or vocation **and a total amount equal to the cost of acquisition or the cost of construction, as the case may be, of such capital asset has been granted as allowance for depreciation of such capital asset**, the full amount of the proceeds of such disposal, whether such disposal takes place while such trade, business, profession or vocation continues or on or after its cessation, **shall be treated as a receipt of such trade, business, profession or vocation in ascertaining the profits and income within the meaning of paragraph (a) of section 3"**.

This is the situation in (a) above, sans the condition, only the part of the proceeds not in excess of the cost is taxed as profit, which is,

> "(a) **When the total of the allowances granted for depreciation is equal to the cost of acquisition there is no loss.** The whole of the proceeds of disposal is profit or gain. Part of the proceeds of disposal not in excess of the cost of acquisition is taxed as profit of the trade or business".

Section 25(3)(b) says,

"(b) Where any person disposes of any capital asset used by him in producing the profits and income of any trade, business, profession or vocation carried on or exercised by him **and an allowance for depreciation has been granted in respect of that capital asset but the total amount of such allowance is less than the cost of acquisition or the cost of construction, as the case may be, of such capital asset**, the excess of the proceeds of such disposal over the difference between the cost of acquisition or the cost of construction of such capital asset, and the total allowance for depreciation granted in respect of such capital asset, shall, whether such disposal takes place while such trade, business, profession or vocation continues or after its cessation, **be treated as a receipt of such trade, business, profession or vocation, in ascertaining the profits and income of such trade, business, profession or vocation, within the meaning of paragraph (a) of section 3:...**"

The situation in (f) above is,

"**When the total allowance for depreciation is less than the cost of acquisition or cost of construction the owner is indemnified for the loss of capital by the deduction of the difference from the proceeds of disposal**".

An example of this situation, as quoted above, is

(1) Cost is Rs. 1,000,000/-

(2) Depreciation Allowance Rs. 400,000/- less

(3) **Proceeds of Disposal** is Rs. 1,000,000/-

(4) Difference between Cost and Depreciation Rs. 600,000/-

If one takes, the "deduction of difference" means, Cost minus Depreciation,

(5) Excess of Proceeds over (3) [(1) – (2)] is Rs. 1,000,000/- - (Rs. 1,000,000/- - Rs. 400,000/-) = Rs. 400,000/- taxed as profit.

(02) Example by the respondent:-

It is pertinent to observe, the example on calculation shown by the respondent in his further Written Submissions, dated 15.03.2022.

> *"When a full depreciation is allowed*
>
> *If a full depreciation allowance is granted in terms of paragraph (a), then the FULL amount of the proceeds of the sale of capital assets is liable for income tax as if it were a business income (or income from trade, profession or vocation) in terms of section 03.*
>
> *When a partial depreciation is allowed*
>
> *If only a partial allowance is granted for depreciation, in terms of paragraph (b), income tax will have to be paid on "the excess of the proceeds" over the "difference between the purchase price and the depreciation allowance".*

Is this what, part two of section 25(3)(b) says,

> "…the excess of the proceeds of such disposal over the difference between the cost of acquisition or the cost of construction of such capital asset, and the total allowance for depreciation granted in respect of such capital asset, shall,…"

The respondent's example continues,

> *"So for example, assume that I purchase a machine for Rs. 1,000,000/- and sell it for Rs. 5,000,000/-. Let us say my depreciation allowance is Rs. 500,000/-. Then the difference between the purchase price [1,000,000/-]*

and the depreciation allowance [500,000/-] is 500,000/. Then I have to pay income tax as follows:-

Rs. 5,000,000/- - Rs. 500,000 = 4,500,000/-

(proceeds) - (depreciation allowance) = (sum liable for income tax)".

But, as per part two of section 25(3)(b), it is not Proceeds – Depreciation.

There is a difference.

It is Proceeds – (Cost – Depreciation) = Taxable Amount

In the above example of the respondent, no difference in the answer is caused because depreciation is Rs. 500,000/- and Cost being Rs. 1,000,000/-, the difference is also Rs. 500,000/-.

But this is not true in every case.

If in the above example of the respondent, the Cost is Rs. 1,000,000/-, Proceeds Rs. 5,000,000/- and Depreciation is Rs. 600,000/-, what will be the taxable amount?

As per section 25(3)(b) it should be,

Rs. 5,000,000/- - (Rs. 1,000,000/- - Rs. 600,000/-) = Rs. 4,600,000/-.

When the Depreciation was Rs. 500,000/- [in the example of the respondent] the taxable amount was Rs. 4,500,000/-.

This will make the situation in section 25(3)(b) not similar to what the common sense in Investopedia said, "The larger the depreciation expense, the lower the taxable income, and the lower a company's tax bill…"

Take another example where the Cost is Rs. 1,000,000/-, Proceeds Rs. 5,000,000/- and Depreciation Rs. 800,000/-. The taxable amount will be,

Rs. 5,000,000/- - (Rs. 1,000,000/- - Rs. 800,000/-) = 4,800,000/-

Now what if Depreciation is equal to the Cost?

Rs. 5,000,000/- - (Rs. 1,000,000/- - Rs. 1,000,000/-) = Rs. 5,000,000/-.

The above situation is what section 25(3)(a) says.

It said,

> ""(3) (a) Where any person disposes of any capital asset used by him in producing the profits and income of any trade, business, profession or vocation **and a total amount equal to the cost of acquisition or the cost of construction, as the case may be, of such capital asset has been granted as allowance for depreciation of such capital asset**, the full amount of the proceeds of such disposal,..."

(03) Harmony between the two sections:-

The Full Amount of Proceeds in the above example of the respondent is Rs. 5,000,000/-.

Hence, if the formula "Proceeds – (Cost – Depreciation) = Taxable Amount, which was used earlier in examples that were made changing only the amount of Depreciation in the example of the respondent, is applied, the basis of section 25(3)(b) is in harmony with that of section 25(3)(a).

It is not so, if the formula used in the example in respondent's Written Submissions is used.

It was,"...(proceeds) - (depreciation allowance) = (sum liable for income tax)".

If that is used in two later examples, in which, depreciation was Rs. 600,000/- and Rs. 800,000/-, the taxable amount will be,

Rs. 5,000,000/- - Rs. 600,000/- = Rs. 4,400,000/- and

Rs. 5,000,000/- - Rs. 800,000/- = Rs. 4,200,000/-

But, if it is applied to a situation, in which, the Cost equals Depreciation, it has to be,

Rs. 5,000,000/- - Rs. 1,000,000/- = Rs. 4,000,000/-

But, this is not what section 25(3)(a) that deals with the last said situation says.

Section 25(3)(b) says,

> "(b) Where any person disposes of any capital asset used by him in producing the profits and income of any trade, business, profession or vocation carried on or exercised by him **and an allowance for depreciation has been granted in respect of that capital asset but the total amount of such allowance is less than the cost of acquisition or the cost of construction, as the case may be, of such capital asset**, the excess of the proceeds of such disposal over the difference between the cost of acquisition or the cost of construction of such capital asset, and the total allowance for depreciation granted in respect of such capital asset, shall,..."

The above section says,

(1) The Depreciation is less than the Cost
(2) The excess of Proceeds over the difference between Cost and Depreciation must be found and
(3) That is the amount to be taxed

According to the above example of the respondent, what if proceeds are less than the cost?

If cost is Rs. 1,000,000/-, proceeds are Rs. 600,000/- and depreciation allowance is Rs. 500,000/-.

Then according to respondent's example,

(a) Rs. 600,000/- - Rs. 500,000 = Rs. 100,000/-

According to the formula Proceeds - (Cost – Depreciation) = Taxable Amount

(b) Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 500,000/-) = Rs. 100,000/-

If cost is Rs. 1,000,000/-, proceeds are Rs. 600,000/- and depreciation allowance is Rs. 400,000/-.

Then according to respondent's example,

(c) Rs. 600,000/- - Rs. 400,000 = Rs. 200,000/-

According to the formula Proceeds - (Cost – Depreciation) = Taxable Amount

(d) Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 400,000/-) = Rs. 0/-

Hence, when Depreciation is low the Tax is also low. [Compare (b) and (d) above]

If Depreciation is more the Tax is also more.

(04) What if the difference between Cost and Depreciation exceeds proceeds?

It could be assumed, proceeds Rs. 600,000/- Cost Rs. 1,000,000/- and Depreciation Rs. 200,000/-. Then it will be,

Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 200,000/-) = Rs. 200,000/- minus

This situation is addressed by the first Proviso to section 25(3)(b) which says,

> "Provided that where such difference exceeds the proceeds of such disposal, the excess shall be treated **for the purpose of subsection (1),** as an expense incurred in the production of income:..."

This shows, that, in such a situation the formula should be,

(Rs. 1,000,000/- - Rs. 200,000/-) – Rs. 600,000/- = Rs. 200,000/- expenditure

(Difference) - (Proceeds) = (Expense Incurred)

(05) Section 25(1) et seq. :-

The "side note" to section 25(1) says, "Deductions allowed in Ascertaining profits and income".

Section 25(1) provides, that,

> "25(1) Subject to the provisions of subsection (2) and (4), there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof, including –
>
> (a) An allowance for depreciation…"

But, as it was said, the arrangement in section 25(3)(a) and (b) is that when Depreciation is more Tax will be more. This appears to be, that, in such a situation the "Gain" is more.

It must be noted, that in the above passage from E. Goonerathne, before the parts referred to above as (a) to (f) he says,

> " "**Depreciation is a loss of capital**. Where an allowance for depreciation has been granted in respect of a capital asset used in a trade or business the total of the allowances granted in previous years must be brought **into the computation of a capital gain arising on the disposal of such asset**…"

Hence, what is taken into account is the "capital gain".

As it was seen, under section 25(3)(b),

Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 500,000/-) = Rs. 100,000/-

Proceeds Cost Depreciation Taxable Amount

Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 400,000/-) = Rs. 0/-

Proceeds Cost Depreciation Taxable Amount

When Depreciation is more Tax is more, because, section 25(3)(b) in its part two takes the Difference between Cost and Depreciation to see how much of proceeds are over that amount, which is the taxable amount.

Under the first Proviso to section 25(3)(b), if the Difference exceeds the Proceeds, then the excess (of Difference – Proceeds) is an expense incurred in the production of income.

This fact too shows, that, if it is otherwise (i.e., when Difference does not exceed Proceeds), the Excess in Proceeds is taxable.

Therefore, the above is the effect of section 25(3)(b).

(06) The decisions of the Commissioner General and the TAC:-

The respondent's written submissions dated 15.03.2022 says,

> "**Accordingly, the respondent respectfully submits that section 25(3) has no relevance to this case**. Indeed, the Tax Appeals Commission whose determination is appealed to Your Lordships' Court did not even consider this argument. While reference is made to section 25(3) in the Tax Appeals Commission's determination [see page 07 of the determination] it was never invited to actually consider the question whether the grant of a depreciation allowance (whether in full or in part) is a pre condition for liability.
>
> This appears to be a new ground raised in appeal to Your Lordships' Court. There appears to be no material to show that this was even a ground of appeal urged by the appellant before the Commission…"

But it was the respondent himself, who raised the matter with section 25(3) before the Tax Appeals Commission and it considered the said matter substantially, not only referred to it.

The determination of the Tax Appels Commission says, at page 06,

> "The respondent has submitted further, as follows,
>
> "Board of Investment Sri Lanka is the legal authority with regard to tax exemption relating to the enterprise entered into agreement with the BOI.
>
> Therefore the attention was drawn to the following view expressed by the BOI in their letter dated 29.08.2010 addressed to the appellant company.
>
> **"Please note that any income generated by your enterprise other than the activity approved by the said agreement is liable for the payment of income tax and other applicable tax if any".**
>
> It is crystal clear that the BOI has not intended to give tax exemption to any other profit generated other than the activity approved by them.
>
> **Therefore the profit generated out of disposal of capital assets has to be computed according to the provision of Inland Revenue Act No. 10 of 2006 and tax treatment of such disposal is set out under section 25(3)(a) of the same Act**.
>
> For the purpose of computation of statutory income, the appellant company has to claim capital allowance according to the section 25(3)(a) of the Inland Revenue Act No. 10 of 2006".

[Emphasis added in the determination of the Tax Appeals Commission]

The determination of the Tax Appeals Commission, then, having reproduced section 25(3)(a) also reproduced section 25(3)(b) thereafter [at page 07] and said at page 12,

> "**Therefore, in the present case, the profits made by selling property, plant and machinery is to be recognized as an income under section 25(3)(b) and not under section 25(3)(a) as determined by the respondent.** Section 25(3)(a) deals with situations where total cost of

assets has been granted as an allowance for depreciation. Accordingly, under section 25(3)(a), the full amount of proceeds of such disposal of assets has to be treated as receipt of the business. However, in the present case the income of Rs. 59,590,954/- is not the full proceeds of the disposal. In fact, it is the surplus earned by selling the capital assets. **This surplus figure would be similar to the outcome of the computation to be made under section 25(3)(b) to ascertain the income of such disposal"**. [Emphasis added in this judgment]

Hence it was the respondent himself, who submitted to TAC that section 25(b)(a) is the relevant section. But the TAC decided that what is applicable is section 25(3)(b).

As it was seen, under section 25(3)(b),

Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 500,000/-) = Rs. 100,000/-

Proceeds Cost Depreciation Taxable Amount

Rs. 600,000/- - (Rs. 1,000,000/- - Rs. 400,000/-) = Rs. 0/-

Proceeds Cost Depreciation Taxable Amount

If what was meant by the TAC as "surplus figure" is similar to Rs. 5,000,000/- - Rs. 1,000,000/- = Rs. 4,000,000/-, in the example of the respondent's Written Submissions, that is not what is calculated under section 25(3)(b) which as the TAC thought the "outcome of the computation" in section 25(3)(b).

What the computation in section 25(3)(b) gives is Excess of Proceeds over the Difference between Cost and Depreciation.

(07) Does section 25(3) apply?:-

Anyway, that being a matter of computation, does section 25(3)(b) apply, to the sale of capital assets by the appellant?

As stated in paragraph 22 of the appellant's Written Submissions dated 27.09.2019 it is stated at page 12 of the determination of the TAC,

> "Therefore, in the present case, the profits made by selling property, plant and machinery is to be recognized as an income under section 25(3)(b) and not under section 25(3)(a) as determined by the respondent…"

But the position of the appellant, as adverted to in paragraph 23, et seq., of the said Written Submission is that neither section applies, as there was no evidence of granting an allowance for depreciation.

The appellant reiterates, that, in order to apply section 25(3)(b), as determined by the TAC the granting of a depreciation allowance is a precondition.

This argument is refuted in the further Written Submissions of the respondent dated 15.03.2022. It is stated,

> "The appellant is distorting this section [section 25(3)] by suggesting that the liability [to] pay income tax is conditional upon the grant of a depreciation allowance. This is NOT what the section says….The Assessor does not grant a depreciation allowance on his own accord. A depreciation allowance must be claimed by the taxpayer. There is no material before Your Lordships' Court to show that such an allowance was ever claimed. Indeed, if the appellant's argument was correct (which it isn't) then an absurdity will result: you can evade liability with respect to the proceeds from the sale of capital assets by simply not claiming a depreciation allowance".

The **Inland Revenue Ordinance of Hong Kong [Chapter 112]** in its first section, under Part 06 on "Depreciation, etc." provides,

> "(1) Where any person is, at the end of the basis period for any year of assessment, entitled to an interest in a building or structure which is a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction

of that building or structure, **an allowance for depreciation by wear and tear of that building or structure, to be known as an "annual allowance", of an amount equal to, subject to subsection (2), one-twenty-fifth of the expenditure, shall be made to the person for that year of assessment**. (Amended 12 of 2004 s. 9)…"

Hence, the depreciation allowance, which is to be known as an "annual allowance", **shall be made to [that] person**.

There is no corresponding provision in the Inland Revenue Act No. 10 of 2006.

Act No. 10 of 2006 uses the word "depreciation" in relation to "an allowance of depreciation" in 23 places and in all such instances it speaks of allowances granted on depreciation. It never says the allowance "shall be made to a person".

The appellant did not declare the proceeds of sale. Paragraph 05 of Case Stated says,

> "05. The appellant has declared "interest income" in their income tax return submitted for the year of assessment 2007/2008 and paid tax at the rate of 15% and declared and adjusted trade profit as exempt. However, in the audited Annual Financial Statement of the appellant company for the financial year 2007/2008, a profit from disposal of assets amounting to Rs. 59,590,954/- was shown but it was not declared in the tax return. The Assessor has rejected the assessment stating that the tax exemption on income is available only in respect of the said "business of the appellant" as approved by the BOI and not in respect of the profit from the disposal of property plant and equipment which is not exempt under the BOI agreement".

Therefore, the appellant has not claimed an allowance for depreciation.

As already said, the argument of the appellant is, that, since the appellant has not claimed an allowance on depreciation, section 25(3)(a) or 25(3)(b) will not apply.

But this cannot be accepted, because, as the respondent has argued, a party can then avoid the applicability of the said section by not claiming an allowance.

There is nothing in Act No. 10 of 2006 about claiming of a depreciation allowance or the result of not claiming it. Section 25(7) provides,

> "(7) For the purpose of this section—
>
> (a) "allowance for depreciation", in relation to any capital asset, means any allowance which is deductible in respect of that asset under-
>
> (i) paragraph (a) of subsection (1) of this section;
>
> (ii) paragraphs (a), (b), (bb) or (d) of subsection (1) of section 23 of the Inland Revenue Act; No. 38 of 2000 ; or
>
> (iii) paragraphs (a), (b), (c), (d), (e), (ee), (eee) or (eeeee) of subsection (1) of section 23 of the Inland Revenue Act, No. 28 of 1979;..."

Section 25(1) was referred to above. It was the section which provides for the deduction of "all outgoings and expenses" including "an allowance on depreciation". Section 23 (1) of Act No. 38 of 2000 was similar to section 25 (1) of the Act in 2006. Section 23(1) of Act No. 28 of 1979 is also similar. These sections say that allowances of depreciation is a deduction. But, as it was seen, section 25(3)(b) provides that it was the difference between the Cost and Allowance of Depreciation which can be deducted under section 25(1).

The position of the appellant is if allowance on depreciation is not claimed, there is no such allowance.

It was seen, that, section 25(3)(a) and 25(3)(b) are drafted in such a way that, if there is no allowance on depreciation the tax is lower. Hence the appellant cannot be right as the respondent argues.

(08) The argument in this regard by the respondent:-

In this regard, the following argument taken by the respondent in its further Written Submissions dated 15.03.2022 is applicable.

In a very philosophical and jurisprudential way, the said Written Submission filed by the respondent says, "*While the regular citizen pays a substantial part of his earnings as income tax, a certain class of people is relieved of the obligation to pay tax. Ironically, tax exemptions are afforded to wealthy entrepreneurs while the struggling middle class continue to be burdened with taxes. Thus, it is important to understand and appreciate the justification underlying tax exemptions. It is only then can this Court properly interpret the scope of tax exemption*". The Written Submission then explains how the Free-Market Economies are driven by the initiative of entrepreneurs, who are prepared to risk significant capital to accumulate personal wealth but, in the process, creating employment opportunities, effectively relieving the State from the burden of providing the same. Hence such enterprises are given a tax holiday.

When that argument is applied and the result of section 25(3)(a) and 25(3)(b) are to increase taxes, when the allowance on depreciation is more, the result of not claiming allowance, should be to regard 100% depreciation is applicable and the entire sum earned from proceeds of sale is the profit. **Hence the Assessor was correct.** What is applicable is section 25(3)(a) and the Full Amount of proceeds of sale (not only the surplus amount computed on Full Proceeds minus Cost of Acquisition or Cost of Construction) is taxable.

Section 25(3)(c) is not applicable even according to the appellant, because that section deals with an occasion, in which, an exemption is granted under Act No. 10 of 2006 itself.

Section 25(3)(c) says,

> "(c) Where a person carrying on any undertaking, the profit and income of which are wholly or partly exempt from income tax under this Act, disposes of any capital asset used for the purposes of that undertaking,

such person shall be liable to income tax on an amount equal to the amount ascertained under paragraph (a) or paragraph (b)".

Hence the only question to be considered is, whether, the BOI Agreement referred to in this case exempts the appellant from paying taxes as per section 25(3)(a) on its sale of capital assets.

(09) Clause 08(1) of the BOI agreement:-

Clause 8(1) of the BOI Agreement dated 27.05.2004 makes the appellant entitled for income tax exemption for 05 years. The Year under review 2007/2008 is within that period. Hence if the BOI Agreement applies to sale of capital assets the appellant is exempted from paying income tax.

Clause 08 of the said Agreement reads,

"(8) In accordance with and subject to the powers conferred on the Board under section 17 of the said Law No. 04 of 1978 and regulations that may be applicable thereto the following benefits and or exemptions or privileges are hereby granted to the Enterprise **in connection with and or in relation to the business** in the Zone.

(i) For a period of five (05) years reckoned from the year of assessment as may be determined by the Board (hereinafter referred to as "the tax exemption period") the provisions of the Inland Revenue Act No. 38 of 2000 relating to the imposition, payment and recovery of income tax in respect of the profits and income of the Enterprise shall not apply to the profits and income of the Enterprise".

As the appellant also submits, the operative words are, "**in connection with and or in relation to the business".**

The appellant also submits, that, the TAC in its determination said,

"This section clearly states that, any plant, machinery etc., become capital assets in relation to a business, once it is used for such business.

> Therefore, when any capital asset is taken away for disposal, it becomes an input which is not used in relation to the "business"".

The "section" referred to by the TAC is section 25(7)(b) of Act No. 10 of 2006.

Immediately before the aforequoted passage, the determination of the TAC said,

> "According to aforementioned Clause 08 (Part II of the first agreement) and Clause 02 (Part II of the second agreement) with the BOI, such profits or income earned by selling inputs falls completely outside the scope/objectives of the BOI agreement.
>
> Section 25(7)(b) of the Act reads as follows,
>
> [For the purpose of this section]
>
> "(b) "capital asset" in relation to a trade, business, profession or vocation means any plant, machinery, fixture, fitting, utensils, articles or equipment **used for the purpose of producing the income in such trade, business, profession or vocation**…" [Emphasis added in this judgment]

According to paragraph 66 of Written Submissions of the Appellant, the TAC has also said,

> "In the circumstances, we are of the view that the profit made amounting to Rs. 59,590,954/- is to be recognized as an income, outside the income of the "business" exempted from tax under BOI agreement".

It appears to this Court, that, the above statement of the TAC is correct, because section 25(7)(b) defines "capital assets" for the purpose of section 25. It was seen that section 25 commences saying,

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

Section 25(7)(b) says, "…any plant, [etc.,] "**used for the purpose of producing the income in such trade, business, profession or vocation…"**

When a plant, etc., is sold, it is not used for the purpose of producing the income in such trade, etc.

In paragraph 66 of the Written Submissions, the appellant states,

> "It is submitted that there is a necessary nexus with the manufacture of rubber by using the machinery by the appellant".

But using the machinery is not selling it.

The appellant submits that the BOI agreement says,

> "The Enterprise shall be entitled to and shall set up/conduct and operate the business…"

and hence the "scope of the business" includes setting up, conducting and operating the business.

But does setting up, conducting and operating include selling?

Clause 08 says, "…the following benefits and or exemptions or privileges are hereby granted to the Enterprise in connection with and or in relation to the business…"

(10) "In connection with" and "in relation to":-

In regard to the phrase "in connection with" and "in relation to", the appellant submits at paragraph 65 of written submissions that, in the case of **Ashville Investments Ltd., vs. Elmer Contractors Ltd., (1988) 2 All E. R. 577 at 589**, the words "in connection with" has been interpreted widely to cover claims for rectification and damage for innocent misrepresentation inducing the contract.

The statement the appellant quotes was said by Balcombe L. J., where it was said,

> "There is one further principle of construction that in my judgment supports the meaning which I attribute to this clause, viz. that all the words used should, so far as possible, be given a meaning. Disputes as to the construction of the contract, or as to matters arising under the contract, are covered by the opening words of a clause. So disputes as to the matters arising in connection with the contract must be taken to refer to disputes other than about questions of construction, or as to matters arising under the contract. Asked to suggest a dispute that arose in connection with the contract which was neither a matter of construction nor arose under the contract, counsel for Ashville was only able to suggest a question whether the contract had been frustrated by some supervening event. **I can see no reason why the words should be limited only to matters that arose after the making of the contract and should not include matters which happened before the making of the contract, provided that they are connected with the contract**". [Emphasis added in this judgment]

To understand, in what context, the above statement was made, it is sufficient to refer to the following two passages, one from the judgment of May L. J., (at page 580) and the other from Balcombe L. J., (at page 588), which occurs just one passage before the passage quoted by the appellant.

> "Consequently, in their points of claim Elmer [the contractor] seek, inter alia, rectification of the contract on the ground that it was entered into between themselves and Ashville [the building owners] as a result of either a mutual, or alternatively a unilateral mistake. Elmer also seek damages allegedly sustained by them as a result of an innocent misrepresentation and or a negligent misstatement made to them by Ashville's representative which induced them to enter into the contract about which they now complain". (at page 580)

"On the other hand, simply as a matter of the words used, which are of the widest import, I can see no reason why both these disputes, viz. as to mistake leading to notification and as to misrepresentation or misstatement leading to damages, should not in each case be a dispute as to "any matter or thing of whatsoever nature arising…" in connection with the contract**. As on any question of construction the issue is incapable of much elaboration: it is a matter of how the words strike the reader**. However, I find that the meaning which I give the words as a matter of first impression is supported by the approach to the arbitration clause which counsel for Elmer submits, correctly in my view, that we should adopt". [Emphasis added in this judgment]

Therefore, in **Ashville Investments vs. Elmer Contractors**, it was a question of considering both the, mistake leading to notification and misrepresentation or misstatement leading to damages, as matters "in connection with" the contract.

The term in question, in this case, "to set up/conduct and operate its business to manufacture solid rubber wheels with plastic steel rims…", is different.

Setting up is something taking place at the beginning. Conducting and operating follows it. Those two concepts too are different. But the concept in question in this case is selling capital assets. That does not fall under "setting up", "conducting" or "operating". Selling the machinery is the opposite of "setting up". It is the ceasing of "conducting" and "operating".

Hence **Ashville Investments vs. Elmer Contractors** does not help the appellant.

(11) Exemption in a "taxing statute" and an "agreement":-

The appellant has further cited cases **Sohli Captain vs. Commissioner of Inland Revenue 77 NLR 350** and **Nanayakkara vs. University of Peradeniya (1991) 1 SLR 97** decided by S. N. Silva J. (as his Lordship then was) that no

restriction should be placed on any provision granting an exemption in a "taxing statute".

These judgments are correct. But the exemption, if any, in this case is not found in a "taxing statute". It is found in the BOI agreement. There is a considerable difference between a "taxing statute" and an "agreement granting a tax exemption".

A "taxing statute" has a universal application to all those who come under its provisions. The "agreement" is often, between two parties.

By section 08(1) the parties agreed to, confine their agreement, that includes its exemptions, to "setting up", "conducting" and "operating" the business, not to the selling of machinery.

Therefore, the appellant is liable to pay tax as determined by the assessor.

(12) The assessment not being made by the person who rejected self assessment:-

A further question is raised by the appellant, that, rejection of a return and the assessment should be made by the same person. [See., page 26 of Written Submissions of the appellant, paragraphs 71 et seq.]

Replying to this allegation, the respondent, in Written Submissions dated 15.03.2022 says that the objection is not clear and it is perfunctory. There is merit on what the respondent says.

The appellant in this regard relies upon the case of **D. M. S. Fernando vs. Mohideen Ismail [1982] 1 SLR 222**, which is a judgment of 05 Judges of the Supreme Court, including the incumbent Chief Justice N. D. M. Samarakoon, Q. C., where the Court was divided by 03 to 02. [Majority, the Chief Justice, Justices Wanasundara and Weerarathne; Dissent, Justices Sharvananda and Wimalarathne]

In **ACL Cables Pvt., Ltd., vs. Commissioner General of Inland Revenue**, **C. A. Tax 07 2013**, this Court having considered the above case and ***Ismail vs. Commissioner of Inland Revenue*** **[(1981) 2 Sri.L.R. 78]** [Principle judgment by Justice Victor Perera] stated,

> "Having examined the said two judgments in detail, this court wishes to take a somewhat different view [Different, to CA(TAX) 17/2017 decided by another division of this court] of the pronouncements of the Court of Appeal and the Supreme Court fourty years ago. The learned Chief Justice who wrote the leading judgment of the majority of the court that was divided 03 to 02 mainly echoed what Justice Victor Perera who wrote the longest judgment in the Court of Appeal said referring to the procedure and the history of legislation pertaining to income tax in this country. **Therefore, although the question that came for decision in that case is giving reasons for not accepting the return of income tax, the analysis of provisions by the superior judiciary in the judgments enables one to clearly understand the concepts of "assessment", "notice" or "charge" and "communicating reasons", which is not as simple as making the assessment and sending the same.**
>
> With regard to the question whether making of an assessment was to be coupled with sending notice it may be noted that the Supreme Court by majority decision said at pages 229-230,
>
> > "As I mentioned earlier the law in regard to Taxation now has provisions for self-assessment by the Assessee and provisions for assessment by the Assessor upon a return made by the Assessee. The former does not concern us in deciding this appeal though it may be necessary to refer to some of the provisions of Chapter XIA. It is the latter that requires examination. Income Tax laws were first introduced by the Income Tax Ordinance No. 2 of 1932 (Chapter 242). Subsequently a Wealth Tax and a Gift Tax was imposed and these were consolidated in the Inland Revenue Act No.4 of 1963. All persons chargeable with tax were bound to furnish a return to the Commissioner within a stipulated period (section 8) if he has not already been required to do so by the Assessor in terms of section 82. By virtue of powers vested in him by section 93 the Assessor proceeds to assess that person. Where a person has

furnished a return, the Assessor may if he accepts the return make an assessment accordingly (section 93(2)(a)). Or if he does not accept the return, he may make an estimate of the assessable income, taxable wealth or taxable gifts and assesses him accordingly. (Section 93(2)(b)). In either case he must, if he is to recover Tax, send a Notice of Assessment to the Assesse (section 95)."

The Supreme Court has also said, at page 232-233,

" Let us "break down" the provisions of section 93 (2) of (Amendment) Act No.30 of 1978, in the same way.

1. There is first a decision made not to accept a return. This is indeed an important decision which could entail serious consequences for the assessee.
2. There is next the requirement of making an estimate. This must necessarily be done, otherwise no tax could be collected and the State would suffer. There is no doubt that this is a mandatory provision. For the imposition of tax this is a *sine qua non*. Without it an imposition of a tax will be illegal.
3. The third is a requirement to communicate reasons for the non-acceptance of the return. This is a duty coupled to the power of making an estimate and taxing thereon. It is a direction of Parliament contained in its legislation requiring obedience of a kind. I have no doubt that this provision is a mandatory one."

The Supreme Court further said at page 233-234,

" The primary purpose of the amending legislation is to ensure that the Assessor will bring his mind to bear on the return and come to a definite determination whether or not to accept it. It was intended to prevent arbitrary and grossly unfair assessments which many Assessors had been making as "a protective measure". An unfortunate practice had developed where some Assessors due to pressure of work and other reasons, tended to delay looking at a return till the last moment and then without a proper scrutiny of the return made a grossly exaggerated assessment. The law, I think enabled the department to make recoveries pending any appeal on such assessments.

The overall effect of this unhappy practice was to pressurise the tax payer to such an extent that he was placed virtually at the mercy of the tax authorities. The new law was a measure intended to do away with this practice. Under the amendment when an Assessor does not accept a return, it must mean that at the relevant point of time he has brought his mind to bear on the return and has come to a decision rejecting the return. Consequent to this rejection, the reasons must be communicated to the Assessee. The provision for the giving of reasons and the written communication of the reasons contained in the amendment is to ensure that in fact the new procedure would be followed, more particularly the communication of the reason at the relevant time is the indication of its compliance. The new procedure would also have the effect of fixing the Assessor to a definite position and not to give him latitude to chop and change thereafter. It was therefore essential that an Assessor who rejects a return should state his reasons and communicate them. His reasons must be communicated at or about the time he sends his assessment on an estimated income. Any later communication would defeat the remedial action intended by the amendment."

Considering the position under Act No. 10 of 2006, this Court said in C. A. Tax 07 2013,

"The position under the present Inland Revenue Act No. 10 of 2006 is referred to in section 163 (1) which is as reproduced below,

"163 (1) where any person who in the opinion of an assessor or Assistant Commissioner is liable to any income tax for any year of assessment has not paid such tax or has paid an amount less than the proper amount which he ought to have paid as such tax for such year of assessment, an assessor Assistant Commissioner may, subject to the provisions of subsection (3) and (5) and after the fifteenth day of November immediately succeeding that year of assessment, assess the amount which was communicated to which in the judgment of the assessor Assistant Commissioner

ought to have been paid by such person **and shall by notice in writing require such person to pay forthwith**- …….

(3) Where a person has furnished a return of income, the assessor or Assistant Commissioner may in making an assessment on such person under subsection I ……. Either –

(a) Accept the return made by such person ; or

(b) If he does not accept the return made by that person, estimate the amount of the assessable income of such person and assess him accordingly:

Provided that where an assessor or Assistant Commissioner does not accept a return made by any person for any year of assessment and makes an assessment or additional assessment on such person for that year of assessment, **he shall communicate to such person in writing his reasons for not accepting the return**".

It does not say anywhere, that, the rejection and assessment should be made by the same person.

In a situation, when there is communication between the first assessor and second assessor, as well as, when there is no such communication between them, but still both of them arrive a similar decision, the purpose of the provisions is fulfilled.

Besides, according to the situation referred to by the respondent, in further Written Submissions dated 15.03.2022, it could not have been done anyway, because, the appellant did not declare the sum in question (the profit from the sale of capital assets) and the Deputy Commissioner required the appellant to submit a tax return which was rejected by the assessor was communicated to the appellant and the Notice of Assessment was sent by the Deputy Commissioner.

Hence the said argument of the appellant cannot be accepted.

The "Questions of Law" are answered as follows,

(01) Has the TAC erred in failing to appreciate that the scope of the appellant's "business" as defined in the BOI agreement No. 229 is not restricted to mere manufacture alone but also includes setting up, conducting and operating a business of manufacture?

The above are included, but not selling capital assets.

(02) Is the sale of a capital asset used in the business an activity that is in the connection with and or in relation to setting up, conducting and operating a business of manufacture as contemplated in Clause 08 of the BOI agreement No. 229 read with the definition "business" in the said BOI agreement?

No.

(03) Is there a distinction between "inputs" and "outputs" relevant to a determination of the scope of the exemption granted by the BOI under Clause 08 of the BOI agreement No. 229 read with the definition of business in the said BOI agreement?

Does not arise, in view of answers given to (01) and (02) above.

(04) Are the profits from the sale of capital assets used in the business included in the exemption granted by the BOI to the appellant company under Clause 08 of the BOI agreement No. 229 read with the definition of business in the said BOI agreement and or in terms of the requirement in section 25(3)(b) of the Inland Revenue Act read with section 3(a) of that Act to treat it as profits of the appellant's business?

No. The Full Amount of Proceeds is taxable under section 25(3)(a).

(05) Did the TAC err in applying section 25(3)(b) of the Inland Revenue Act in the absence of evidence of grant of allowance of depreciation by the Inland

Revenue Department in respect of capital assets disposed by the appellant company?

This is discussed in the judgment. The applicable provision is section 25(3)(a).

(06) Has the TAC failed to appreciate that section 25(3)(b) of the Inland Revenue Act should be limited only to a person chargeable with income tax under that Act who obliged by law to claim depreciation allowance under section 25(1) of that Act?

Being obliged under the law to claim an allowance for depreciation, the appellant cannot avoid been taxed under section 25(3)(a) by not claiming such an allowance.

(07) Has the TAC failed to appreciate that section 25(3)(a) or 25(3)(b) of the Inland Revenue Act should be applicable by virtue of section 25(3)(c) only to a person who has been granted an income tax exemption under that Act subject to the taxation of the sale of any capital assets?

Section 25(3)(a) and 25(3)(b) applies even without section 25(3)(c) and the latter is not a precondition to apply the former.

(08) Is the assessor who rejected the return of income of the appellant for 2007/2008 by the letter dated 16.09.2009 also obliged to make the assessment on the appellant and or issue a notice of such assessment on the appellant?

No.

(09) Did the TAC err in determining that "the relevant assessment was made by an assessor", without any evidence before the Commission to support that finding?

The decision of the TAC in this regard is not illegal, for reasons given in this judgment.

(10) Has the TAC erred in applying section 195(1) of the Inland Revenue Act in respect of an instance of failure by the assessor who rejected such return of income of the appellant to make the assessment on the appellant and or issue notice of such assessment on the appellant?

No.

Hence the appeal in the form of a Case Stated is dismissed.

Judge of the Court of Appeal.

Hon. Sasi Mahendran,

I agree.

Judge of the Court of Appeal.