5.0 DEDUCTION OF INCOME TAX FROM THE SALE PRICE OF ANY GEM SOLD AT ANY AUCTION CONDUCTED BY THE NATIONAL GEM AND JEWELLERY AUTHORITY (SEC. 161A)

5.1 Application of the Deduction

The National Gem and Jewellery Authority established by the National Gem and Jewellery Authority Act, No. 50 of 1993, shall deduct from the sale price of any gem sold at any auction conducted by it, income tax of an amount equal to 2.5% of the sale price of such gem from the sum payable to the seller of such gem and at the time such sum is paid to the seller.

5.2 Equally Applicable Provisions

Provisions applicable for deduction of income tax by banks or financial institutions with regard to duties after deduction, default, issue of assessment, appeals and penalty for default shall equally applicable for this deduction too.

INCOME TAX CASE LAWS

1.0 PROFITS FROM EMPLOYMENT

The profits from employment are specified in terms of Sec 4 of Inland Revenue Act, No. 10 of 2006. Cases have been decided to clarify what constitutes profits from employment for the purpose of income tax.

Case 01

Craib Vs Commissioner of Income Tax (CTC - Volume I)

Payment of special bonus to superintendent of estate for exceptional services rendered - Personal gift-profits from employment-choice of word not material

The Directors of a company in whose estate the appellant was employed as a Superintendent by resolution granted him "a special bonus of Rs. 10,000 in view of his exceptional services to the company and in consideration of the fact that he had to undergo medical treatment at Home".

In the return furnished by the company this sum was mentioned as a "bonus" paid to the appellant. This sum was assessed as a part of the appellant's income. It was contended by the appellant that it was a personal gift.

Held

(1) that the payment was a personal gift and could not be regarded as profits from any employment within the meaning of section 6(2) (a).

(2) that the appellant should not be penalized for the choice of a word, whether it be deliberate or accidental, by the party making the payment.

(3) that the long service rendered by the appellant to the company was the motive, but not the consideration, for the payment.

The mere fact that payment is made to employee as a result of or in connection with his employment is not enough to render the payment liable to tax. Thus, a special bonus paid to employee in view of his exceptional service to the company and in consideration of the fact that he had to undergo medical treatment at home and abroad was held to be not profit from employment.

Case 02

Sutherland Vs Commissioner of Income Tax (CTC - Volume I)

Employee of Company - Ex gratia payment made by the company to wife of employee after his death - profits from employment

S, the husband of the appellant, was the employee of company. Shortly after his death the following resolution was passed by the board of directors of the company:

"The directors having taken note that a sum of Rs. 15,750 had been placed to reserve to meet the continent liability to pay for Sutherland's leave pay which he would have been entitled to if he had survived, it was decided to pay Mrs. Sutherland's passage to England, namely Rs. 1,502, and to authorize a payment to her of Rs. 15,750"

A letter written two days after the resolution stated that "a further sum of Rs. 15,750 is to be paid to Mrs. Sutherland in respect of the late Mr. Sutherland's overdue leave pay".

There was no evidence that payment was made to Mrs. Sutherland as the executrix of the estate or that it was a debt due from the company to the deceased. The appellant was assessed to income tax in her capacity as executrix in respect of the above sums as forming part of the profits from the deceased's employment within the meaning of section 6(1) (b) and section 6(2)(a) (I) and (v).

Held

(1) that the circumstance that at various times the company's officials chose such expressions as "overdue pay leave" and "accumulated furlough pay and passage money due to the late Mr. S" to describe the nature of the payment had no bearing on the nature of the payment.

(2) that the payment in question was a gift to the appellant personally of sum of money to which the deceased was not entitled and was not a payment made to her in her capacity of executrix.

(3) that it was not a profit from the deceased's employment within the meaning of section 6(1) (b) and section 6(2) (I) and (v) of the Income Tax Ordinance.

The decision was on the basis that the motive for the gift was the circumstances that it represented a sum of money the husband would have been entitled to if he survived though he died before he became entitled to it. The Court also took into account that there was no evidence of an express contractual obligation of the company to pay the leave pay to the deceased.

Case 03

Kanagasbapathy Vs Commissioner General of Inland Revenue (SLTC - Volume IV)

Profits from employment - Monies received under a Health Insurance Scheme as reimbursement of medical expenses incurred in respect of assessor's mother. Does it fall within the definition of "Profits fro employment" in Section 3(4)(a) of Act No. 4 of 1963. Is this definition different from expression in Section 6(2) (a) of the Income Tax Ordinance (Chapter 242) - Burden of proof.

Appellant an employee of the Central Bank received under its Health Insurance Scheme reimbursement of medical expenses incurred by his mother, a dependent relative eligible under the scheme. Assessee's position was his mother and not himself and therefore does not constitute his "profits from employment "within the meaning of the Income Tax Ordinance (chap. 242) of the Inland Revenue Act, No. 4 of 1963.

The court of appeal held that it was the Assessee who was entitled to the payment and that such payment fell within the meaning of the section 3 (I) (b) read with section 3(4) (a) (i) of the Inland Revenue Act, No. of 1963.

Held

(1) The kinds of receipts enumerated in the statue beginning from "wages" going down to "perquisites" are receipts in respect of a person's service as an employee. The receipt must be one derived by reason of his employment. They must be receipts which can employee receives in the course of his employment.

(2) Our law is not in any way different in this regard from the position obtaining in the U. K. The Court must be satisfied that the service agreement was the "causa causana and not merely the causa sino quo non" of the receipt of the profit. The test is whether the payment made by way of reimbursement for medical expenses incurred in respect of his mother was received by him in return for acting as or being an employee.

(3) In tax cases it is always necessary to remind oneself that when it is sought to impose a tax on the subject, the burden is always on the revenue authorities to prove that tax is exigible.

(4) The interpretation placed by the Court of Appeal on the amending provisions is too wide and not justified by either the wording or the context.

(5) The receipts are not taxable and the appeal is allowed.

The benefit conferred to the employee or the member of his family are liable as profit from employment of such employee if it can be established that the benefit received is a reason of his employment. The benefit to be liable for tax must be received in return for acting or being an employee and it is not enough

for the tax in authorities to establish that the benefit would not have been received had he not been an employee.

"The essential point is that what was paid to an appellant was paid to him in respect of his personal situation, for he had taken advantage of the Health Insurance Scheme and accordingly entitled to an indemnity. The payment, which was a reimbursement of a expenses of his mother's illness, had, if at all, only a remote connection with his service. The payment from a distress fund or a fund of a similar nature would *prima facie* indicate that such funds are set up by the employer for the benefit of the employees whose personal circumstances justify assistance. Such payment cannot, in my view be regarded as a profit from employment."

Wanasundera J, in Kanagasabapathy v. CGIR: 4 CTC 131

2.0 PROFITS AND INCOME ARISING IN OR DERIVED FROM SRI LANKA

Insurance, Sales and Disposals in Sri Lanka (Sec 80)

Where a person in Sri Lanka acting on behalf of a non-resident person,

- Effects or is instrumental in effecting any insurance.
- Sells or disposes of, or is instrumental in selling or disposing of any property,
- Where the property is in Sri Lanka or is to be brought into Sri Lanka; and
- Whether the insurance, sale or disposal is effected by such person in Sri Lanka; or by or on behalf of a non-resident person outside Sri Lanka; and
- Whether the moneys arising there from are paid to or received by the non-resident person directly or otherwise.

The profits arising from any of the following insurance, sale or disposal shall be deemed to be derived by the non-resident person from business transacted by him in Sri Lanka.

The person who acts on behalf of the non-resident person is deemed to be an agent.

Case 01

Anglo-Persian Oil Company Co. Ltd Vs Commissioner of Income Tax (CTC Volume I)

Income Tax-Contract for scale of fuel oil made in Landon by company registered in U.K.- Delivery to ships at Colombo by company's agent-Payment in London-Profits not arising in or delivered from Ceylon-Agent not instrumental in selling

or disposing of property in Ceylon-Section 5 and section 34 of Income Tax Ordinance-Contract of sale or agreement to sell.

This was a case stated for the opinion of the Supreme Court under section 74 of the Income Tax Ordinance.

The assessee (appellant) is the Anglo-Persian Oil Company Limited, registered in the United Kingdom, and its agent in Ceylon is the Anglo-Persian Oil Company (Ceylon), Limited. The appellant company enters into contracts in London with ship owners whose ships call at various ports including Colombo. In Colombo the appellant company had no place of business but stored its fuel oil with its agent, the Ceylon Company which trades in fuel oil as part of its business. The appellant company undertook to supply fuel oil for the requirements of the shipping company's vessels at certain named ports including Colombo and at a stated price. The shipping company on its parts binds itself to buy from the appellant company all the oil requirements of its vessels at the named ports and the total estimated tons of oil for all the ports are stated. The minimum quantity which the shipping company undertakes to buy and the maximum quantity which it may require the appellant to deliver during the period (which is also fixed) are stated. Payment is to be made in London by cash on receipt of the appellant's agent's telegraphic advice of the quantity delivered. Each delivery shall constitute a separates contract. The appellant has the right to suspend or cancel the contract in the event of the shipping company failing to make the payments provided in the contract and in certain other contingencies. The Ceylon company stores the appellant's oil and its oil in tanks built on premises used by the Ceylon company for its own business. When a ship belonging to the shipping company arrives in Colombo a representative of the Ceylon company visits the ship and ascertains the requirements of oil and the required quantity brought in lighters belonging to the Ceylon company and delivered to the ship. A document of delivery and acceptance is signed by the representatives of the ship and the Ceylon company. A copy of this document is sent by the Ceylon company to the applicant in London.

Held

(1) that the property in the goods passed to the shipping company at the time the contract was signed; the Ceylon company being merely an agent for the delivery of the oil, the mere delivery of the oil in Ceylon by them will not bring the profits under the category of "profits arising in or derived from Ceylon" within the meaning of section 5 of the Ordinance.

(2) that the word "disposes" connotes clear and intelligible contractual relations between the agent in Ceylon and the disposee and was not intended to refer to such a detail as a mere delivery. If the agent in Ceylon did not actually effect the contract, or if he was not instrumental

in effecting it, the non-resident would be liable on the profits arising on the contract.

(3) that Section 34 is intended to include contracts which have been entered into as a result of efforts of agents in Ceylon of a foreign principal even when such contracts have been finally concluded outside Ceylon.

Case 02

Chivers & Sons, Ltd Vs Commissioner of Income Tax (CTC Volume I)

Income tax-Sale of goods by non-resident person-Agent forwarding indent to non-resident person-Agent instrumental in selling goods -Liability of non-resident person to pay tax under section 5 (1) (b) read with section 34.

The appellants manufactured goods in England and supplied them to Ceylon F.X. Pereira & Sons, a firm in Ceylon Stocked and sold their goods. The local firm displayed samples of the appellant's goods. They had an indent department which arranged for the supply on orders from local dealers of goods shipped by the appellants and others; they canvassed for orders for the appellants' goods from time to time and also forwarded a form of indent addressed to the appellants if they could not supply the goods from their stocks and received a commission from the appellants on all such orders received and executed. There was no formal agency agreement between the appellants and F.X. Pereira & Sons. The appellants had no sole agent in Ceylon. Sometime dealers placed orders directly with the appellants and in such cases no commission was paid to the local firm. The question was (1) Whether F.X. Pereira & Sons were acting on behalf of a non-resident person within the meaning of section 34 of the Ordinance. (2) Whether they were instrumental in selling or disposing of the appellants' goods. (3) Whether the profits arising to the appellants from the sale of their goods on indents placed through F.X. Pereira & Sons should be deemed to be derived by the appellants from business transacted in Ceylon within the meaning of section 34, and therefore liable to Income Tax under section 5 (1) (b) of the Ordinance.

Held

(1) that the firm in Ceylon were acting on behalf of the non-resident person by stocking, and displaying and keeping samples of goods of the appellants and by canvassing orders for those goods and by receiving commission on those orders.

(2) that the firm in Ceylon were instrumental in selling the appellants' goods within the meaning of section 34.

(3) Section 34 must be read along with section 5 and the effect of section 34 is to include under profits arising in or derived from Ceylon, all profits from the sale of goods where such sale has been brought about through the instrumentality of a person in Ceylon acting on behalf of the seller who is outside Ceylon, and in spite of the fact that legally the transactions of the business or the sale take place outside Ceylon.

3.0 INCOME FROM ANY OTHER SOURCES

Under the Inland Revenue Act, each source of income specified is chargeable with income tax. Having specified each source of income, the last source is specified to cover as a catch all clauses. That is income from any other source not to including receipts of casual and non recurring nature.

Case 01

Wickremasinghe Vs Commissioner of Income Tax (CTC - Volume I)

Fee paid to assessee as arbitrator - Casual and non-recurring nature - Profits from employment - Notice in writing of case stated-Income Tax Ordinance section 6(1) (a), 6 (1) (h); section 74 (3).

The assessee was an ex-Civil servant and a Government pensioner; he was appointed arbitrator by the Colombo Municipal Council in arbitration proceedings connected with the purchase by the Council of the Colombo Tramways. He received a fee of fifteen thousand rupees for acting as arbitrator.

Held

(1) that this was not profit of a casual an non-recurring nature and was taxable under section 6 (1) (h) of the Income Tax Ordinance.

(2) that the delay of two days in giving notice of the case stated in terms of section 74 (3) of the Ordinance did not deprive the Supreme Court of jurisdiction to hear the case.

Semble, that the transaction came within the words "any employment" in section 6 (1) (b); the word 'employment' is not restricted to the case of a man engaged by another.

4.0 ADVENTURE OR CONCERN IN THE NATURE OF TRADE

The term 'trade' has been defined to include every trade and manufacture and every adventure or concern in the nature of trade: s. 217. The definition is a wide one in that it includes profits from isolated transactions when such a transaction is in the nature of trade. Whether a person was engaged in a trade or embarked on an adventure in the nature of trade is a mixed question of fact

of law. The expression 'trade' in the ordinary dictionary sense is "a pecuniary risk, a venture, a speculation, a commercial enterprise" coupled with the statutory definition of trade. The decided cases throw some light of the meaning of what constitute an adventure in the nature of trade.

Therefore, the position is whether particular transaction is to be considered as adventure so that it is a trade profit or capital gains. This is very important because the trade profit is taxed at normal rates, whereas capital gains tax is abolished.

Case 01

D. S. Mahawitharna Vs CIR (CTC - Volume III)

Purchase and sale of property - Adventure in the nature of trade - Scope and nature of power of the Supreme Court to interfere on questions of fact in a case stated Sec. 6(1)(a), 74 of the Income Tax Ordinance (Cap. 188).

The assesses and another acquired an option to purchase an estate of 583 acres and paid a forfeitable cash advance and agreed to complete the purchase within a few weeks. Both had nether the financial capacity nor intention to purchase the estate with their funds or borrowed monies. They quickly procured purchasers for 464 acres of the estate and of the remaining 119 aeries, half was sold and the rest acquired by the government - the proposed acquisition was known to them at the time they acquired their option. It was clear that they did not secure the option in order to purchase the estate for themselves.

Held

(1) that on the facts and circumstances proved in the case the inference that the transactions in question were an adventure or concern in the nature of trade was in law justified. The total impression created in all the circumstances of the case was that the assessee's dominant intention when he entered into that agreement to purchase the estate was to embark on a venture in the nature of trade.

(2) that the Supreme Court has the power upon a case stated to reconsider the inference drawn by the Board of Review as to the assessee's intention only if such inference was based on a consideration of inadmissible evidence or after excluding admissible and relevant evidence or it was unsupported by legal evidence or if it was not a rational conclusion and was perverse and should therefore be set aside.

Case 02

Ram Iswera Vs CIR (CTC - Volume III)

The assessee, a proctor and his wife, resident at Hulftsdorf.

On 3.3.51 his wife entered into an agreement with a Mrs. Thambyah to purchase her land 433 perches in extent situated in Alexandra Place and adjoining St. Bridget's Convent, Colombo. Rs. 45,000 was paid as a forfeitable deposit. The balance Rs. 405,000 was to be paid on or before 20.4.51. Soon after the agreement a sketch was prepared dividing the land into fourteen lots. One lot was reconvened to Mrs. Thambyah as agreed upon earlier. Two lots comprising 70 perches and two lots comprising road reservations were transferred to the Assessee's wife. The balance nine lots were sold to others. In effect she made a net profit of Rs. 66,331 and paid only Rs.15,275 for the 70 perch allotment worth Rs. 87,040.

The Board of Review rejected the assessee's contention that the dominant intention of his wife to live near St. Birdget's Convent to facilitate her children's schooling.

Held

(1) that the transaction as held by the Board was an adventure in the nature of trade.

(2) that in examining the conclusion of the Board of Review on a question of mixed law and fact the Court had to examine whether the Board had applied the relevant legal principles correctly or not. The term "adventure in the nature of trade" postulates the existence of certain elements in the adventure which in law would invest in with the character of trade or business. The transaction will in other words be allied to transactions that constitute trade or business. Even an isolated transaction can satisfy the description of an adventure in the natures of trade. The total effect created on the mind of the court by all the facts and circumstances disclosed in a particular case will be the determining factor. The appeal was dismissed.

The facts accepted by the Board of Review establish that

(1) The assessee or his wife had no money to pay even the deposit. The sum had to be borrowed.

(2) The transaction had to be concluded between 3.3.51 and 21.4.51 a comparatively short period of time.

(3) There was preparation, Organization and activity: within a few days of the agreement of 3.3.51 a sketch was prepared to be shown to prospective purchasers. Soon thereafter a survey plan was made dividing the land into 14 lots, twelve building sites and two roadways, the activity led to the maturing of the assets.

(4) The quantity of extent purchased was far in excess of the alleged requirements of the assessee's wife.

(5) There was considerable profit from the transaction within a short time, i.e. the presence of profit motive, which is a characteristic of trade.

Case 03

Commissioner of Income Tax Vs C. S. De Zoysa (CTC - Volume I)

"Trade" - "Business" - Requirement of repetition of activity - Section 2, 6(1) (h) present 6(1) (j) of Income Tax Ordinance.

The assessee's wife owned a block of land and undivided shares in surrounding lands. These lands had been requisitioned during the war and the Admiralty had erected 10 hangers and some buildings. The assessee after obtaining the permission of the other co-owners and after giving them a certain sum for surrender of their option to purchase and the right to damage compensation agreed to purchase nine of the hangers of Rs. 90,000. The assessee advertised for the sale of these hangars but was unsuccessful. He borrowed a sum of Rs. 45,000 from Senator Cyril de Zoysa on the understanding that one-forth share of the profits of the sale of hangars was to be given to him. Subsequently the hangars and the buildings were sold. The amount of profit made by the assessee after deducting the expenses, the one-fourth share of the profits paid to Senator Cyril de Zoysa and the amount paid to the co-owners was fixed at Rs. 144,000. The assessee was assessed to income tax for the year 1948-49 and to profits tax on these profits for the year 1949. The Board of Review by a majority of two to one decided that the assessments should be disallowed. The Commissioner of Income Tax thereupon applied for a case stated. The question of law for decision was whether the sum of Rs. 144,000 earned by the assessee by the purchase and resale of the hangars fell within the ambit of section 6(1) (a) of the Income Tax Ordinance.

Held

(1) that, for buying and selling to come within the ambit of the expression "trade" there must be some amount of repetition in the acts of buying and selling.

(2) the expression "trade" coupled with such words as "carried on or exercised" makes it beyond question that there should be a repetition of acts of buying and selling to constitute "trades".

(3) that the expression of "business" in section 6(1) (a) means an activity continuously carried on; and in this case it is an isolated transaction of sale wherein the appellant, sought to take advantage of the concession granted to owners of requisitioned land of purchasing the buildings erected thereon.

(4) that an isolated transaction cannot have the characteristic of an adventure in the nature of a trade since it does not involve the repetition of activity. (This principle has been overruled by the Privy Council decision.)

Case 04

Rutledge Vs CIR (14 TC 490)

A money lender who was also interested in a cinema co. while in Berlin was offered an opportunity of purchasing very cheaply a large quantity of toilet papers from a bankrupt German firm. He brought the paper to UK and found a purchaser for the whole quantity. Here one purchase and one sale the defense pointed out that this person did not have a agent as in Lord President Clyde said that (1) in buying a large quantity of toilet paper he entered upon a commercial adventure or speculation (2) The adventure was carried on the same way as any regular trade would do (3) that this adventure is in the nature of trade.

Lord Sands pointed out "the nature and quantity of the subject dealt with exclude the suggestion that it could have.

One would need so much for private use. From beginning to end the intention was to buy and resell.

Case 05

CIR Vs Livingstone and Others (11 TC 538)

In 1924 the respondents a ship repairer, a blacksmith and a fish sales employee purchased as a joint venture a cargo vessel with a view to converting it into a steam ship drifter and selling it. They were not connected in business and they had never previously bought a ship. Intensive repairs and alterations to the ship were carried out. The first two also were employed in their ordinary capacity in trade.

Lord President Clyde said "the test is whether the operations involved in it are of the same kind and carried on in the same way as those which are characteristic of ordinary trading in the line of business in which the venture was made. The respondents collected capital bought the second hand vessel and converted it into a mark table drifter. These operators seem to be the same as those which characterize the trade of converting and refitting second hand articles for sale. Profit is not capital accretion.

Held

The transaction is an adventure in the nature of trade. In this case, an isolated purchase and sale of a ship by a black smith, a ship repairer and a fish sales employee was held to be trading as they embarked on activities to make the subject matter marketable.

Case 06

Frazer Vs CIR (24 TC)

In 1937 & 38 the respondent who was a woodcutter bought through an agent and resold whisky for £ 407. The whisky was sold also through a year in 1940 for £ 1131. This was his sole dealing in whisky. He had no special knowledge of the trade and he did not take delivery of the whisky nor did whisky he have is blended or advertised.

Lord President Normand "it would be extremely difficult to hold that a single transaction amounted to a trade, but it may be much less difficult to hold that a single transaction is an adventure in the nature of trade, but what is more important is the nature of the transaction with reference to the commodity dealt in. The purchase of a large quantity of whisky greatly in excess of what could be used for himself, his family and friends, a commodity which yields no pride of possession which cannot be turned to account except by a process of realization. I can scarcely consider it to be other than an adventure in a transaction in the nature of trade.

The decision was on the ground that when a person deals with a trading commodity such a whisky in bulk, in bond, which he has acquired merely for the purpose of re-sale and proceed to sell and there are no other material circumstances in the case that he engaged in trade and in the trade only and not in investment of capital.

Case 07

CIR Vs Reinhold (34 TC 389)

The resplendent Director of a company bought 4 houses in January 1945 and sold them at a profit in 1947. He admitted that he had bought the property with a view to resale and had instructed his agents to sell whenever suitable opportunity arose.

It was held that the fact that the property was purchased with a view of resale did not itself establish that the transaction was an adventure in the nature of trade.

Lord Carmont. "If the commodity purchased in the single transaction was not a kind normally used for investment, but for trading and if the commodity could not produce an annul return by retention in the lords of the purchaser than the conclusion may be reached the venture was a tardy one. If however the commodity is normally used for investment land, houses etc the inference is not so readily to be drawn for an admitted intention in regard to a single transaction to sell on the arrival of a suitable or selected time and does not warrant the same definite conclusion as regards trading or even that the transaction is in the nature of trade I am satisfied that much more is required to show that the respondent has engaged in an adventure in the nature of trade".

Case 08

Martin Vs Lawry (11 TC 297)

The purchase and sale of a large quantity of linen outside the ordinary occupation of the taxpayer was held to be a trading transaction as the subject matter of the purchase and sale and the methods adopted for the sale excluded the suggestion that it could have been disposed of otherwise than as a trading transaction.

6.0 ANNUITY

What is an annuity for tax purposes?

There is no definition of annuity in the Act. In the absence of a definition, Samarawickreme J., in the case of Rajaratnam v. CIT: derived from the principles applied by the courts in the United Kingdom, formulated certain characteristics that would help to decide whether the particular payment is within the description of a payment by way of annuity. The characteristics of an annuity as formulated by him are

(a) it must be made with reference to the year though it may be paid in periodic instalments, e.g. quarterly or monthly.

(b) not be a receipt or accrual of a capital nature to the payee.

(c) be made under a legal obligation.

(d) be either recurrent or capable of recurrence.

(e) be pure income or profit of the payee.

There are four important tests, which are applied to determine whether a payment is by way of annuity by the courts in the United Kingdom. These tests are to enquire whether

(a) the payment is income and is not capital

(b) the payment is pure income profit

(c) the payment is made under a legal obligation

(d) the payment is recurring or capable of recurrence.

Case 01

The Commissioner of Inland Revenue Vs J.M. Rajaratnam (CTC - Volume III)

Whether annual payments made under deeds of covenant are deductible annuities.

The respondent - assessee made two payments amounting to Rs. 3,000 to his two brothers under two deeds of covenant by which he had undertaken to pay each brother a sum of Rs. 1,500 annually for a period of seven years from the year ending 31st March, 1958, or during the residue of his life, whichever period shall be shorter.

He claimed these amounts as deductible annuities from his assessable income for the year of assessment 1958-59 under section 15(1) of the Income Tax Ordinance.

The deduction was disallowed and he appealed to the Commissioner under section 73(1) of the said Ordinance. At the hearing of the appeal the Deputy Commissioner disallowed the claim on the ground that the word 'annuity' in the United Kingdom Act covered annuities purchased by the expenditure of a capital sum and that payments under deeds of covenant would not be regarded in the United Kingdom Act for tax purposes as 'annuities' but as 'annual payments' and that as the Ceylon Ordinance did not contain the words 'or other annual payments' the payments in question were not deductible.

Thereafter the respondent's appeal to the Board of Review was dismissed on the grounds that the payments "were not attributable to any sources of income and were not therefore expenditure or of an income character".

The respondent's appeal to the Supreme Court, however, was successful, it being held that right to receive recurring annual payments which are income in the hands of the payee can properly be described as an 'annuity' even through the payee has not required the right by purchasing it for a capital sum but in some other way - (as for example by testamentary request or under a voluntary covenant) and that there is no warrant for putting on the word as used as used in the Ordinance which for putting on the word as used as used in the ordinance the limited meaning which the Deputy Commissioner put on it'.

Their Lordships of the Privy Council were in agreement with the Supreme Court decision that the payments under these deeds of covenant can fairly be described as ' annuities''.

6.0 PARTNERSHIP

In this case question arose whether a partnership formed between family members is a valid partnership for income tax purpose.

Case 01

A. A. Davoodbhoy Vs Commissionery General of Inland Revenue (SLTC - Volume IV)

Decision in Court of Appeal

Non - notarial agreement creating a sub-partnership-Father and Children agree to be partners in the profits and losses of the father in the main partnership business - Whether agreement was an artificial or fictitious transaction - Test of genuineness of the agreement-
The test of genuineness will be considerations such as

(a) The position between the parties - for e.g. if there were losses would all the partners to the not notarial agreement have contributed their proportionate share to make good the losses. Where the children were virtually dependent on the father they could not have obtained the money to contribute to the losses.

(b) The conduct of the parties - children had not asked the father to form the sub-partnership.

(c) Knowledge - the children had no worthwhile knowledge of the content of the agreement.

It was held: The agreement was an artificial transaction.

The agreement was not for carrying on a separate business in partnership, but for sharing the father's share of the profits and losses in the firm of Abdulhassen Davoodbhoy. There cannot in law be a valid partnership if the agreement is merely of for the purpose of sharing the profits and losses of one partner in another partnership without anything more.

Decision in Supreme Court

Inland Revenue Act Sections (79(7) and 52 - Agreement by partner to share with children, his profits of a business partnership - Whether agreement is artificial and fictitious - Does it form a sub-partnership which is liable to be taxed. Does it result in a diversion of profits by overriding title. Is the asssessee liable to be assessed for the entirety of the profits.

The appellant Abasbhoy Davoodbhoy was one of five partners of a firm carrying on business under the name of "Abdul Hassen Davoodbhoy" and was entitled to one fifth share of its profits. In order to provide for his children he entered into an agreement (A1) with them, whereby they agreed "to be partners in regard to the one fifth share of the profits and losses of the said Abasbhoy Davoodbhoy. "The agreement stated that the share of the capital and the goodwill in the said business which was the property of the appellant was to remain his separate asset. The only asset of this venture therefore was the one fifth share of the profits received by the appellant. The agreement A1 and the rights claimed under it were rejected by the Assessor in terms of section 79(7) of the Inland Revenue Act and the whole of the one fifth share of the profits was assessed as

the income of the appellant and not as the income of the partied to the agreement A1.

Appeals to the Commissioner General of Inland Revenue and the Board of Review were dismissed. On a case stated by the Board of Review the matter was heard by the Court of Appeal and answered against the appellant. The court of appeal granted the appellant leave to appeal to the Supreme Court as substantial questions of law were involved.

It was contend on behalf of the respondent that A1 was "artificial and fictitious"; that it did not create a sub-partnership but was merely a family arrangement and that the one fifth share of the profits was the income of the appellant which should assessed in terms of section 52 of the Inland Revenue Act, since A1 results in an application of income and not a diversion of same. It was argued that, for a diversion of income there must be a transfer of its source.

Held

(1) The agreement A1 is not "artificial and fictitious". It incorporates a family arrangement which is genuine and very common in our society. The accounts show that this agreement has been acted upon and profits divided accordingly. It cannot be rejected under 79(7) of the Inland Revenue Act.

(2) An arrangement to share profits only, can constitute in law, a partnership between the parties to the agreement, A1 created a "sub-partnership" which term is merely a convenient name used in law and in commercial circles to describe a partnership which is dependent on another partnership. Such an agreement is perfectly valid in Civil law must therefore attract the provisions of the Inland Revenue Act.

Special Note

However, now under Inland Revenue Act partnership has been specifically defined as follows

Partnership shall not include any disposition, trust, grant, covenant, agreement, assignment, settlement or other arrangement by which the share of the divisible profits or the divisible loss, of a partner of any partnership is shared with any other person or partnership.
Accordingly, now any way the partnership stated in the above case cannot be a valid partnership under the Inland Revenue Act.

7.0 CAPITAL & REVENUE EXPENDITURE

Any capital expenses should be disallowed under section 26 of the Inland Revenue Act, No. 10 of 2006, unless such expenses is specifically allowed under section 25.

The cases on this area were to decide whether the expenses were capital or revenue nature.

Case 01

Vallambrosa Rubber Co. Ltd. Vs Farmer (5 TC 529)

This Company had an estate in which in a particular year only 1/7th of the estate produced rubber. The balance 6/7th was immature. The assessor disallowed the expenditure incurred for 6/7 on the grounds.

(i) the expenses cannot be charged, when there is no corresponding receipt.
(ii) expenses on maintenance of immature area was capital.

The judge pointed out that the first argument was defeated by its own absurdity, because if this was so a fruit grower will never be allowed to deduct the necessary expenses, without which he cannot raise the fruit.

On the question of Capita & Revenue, the expenses were necessary every year and I do not say that this consideration is absolutely final or determinative but is a rough way, I think it is not a bad criterion to say that capital expenditure is a thing that is going to be spent once and for all and income expenditure is a thing that is going to recourse every year. Therefore these expenses (weeding, salaries etc.) were of a revenue nature.

Case 02

Hancock Vs General Reversionary & Investment Co Ltd. (7 TC 358)

Deduction of lump sum payment to purchase and annuity equal in amount to pension payable to former employee. This was considered revenue - a lump sum was paid instead of a recurring series of annual payments. The fact that a lump sum was paid instead of recurring series of annual payments does not alter the character of the payment.

The lump sum payment here was made in replacement of an existing revenue liability for it merely compressed into one year a charge which was in its nature recurrent. It was a pension in another form; it is actuarially equivalent in value and it is identical in character and was a payment to meet a continuing demand which by itself is ordinary business expense.

Case 03

Artherton Vs British Insulated & Helsby Cables Ltd. (10 TC 155)

The company claimed a sum of £ 31,784 which it had contributed to form the nucleus of a Pension Fund established by a trust deed for the benefit of its clerical staff. This sum was actuarially ascertained to be necessary to enable past years of service of existing staff to rank for pension.

Held

To be capital nature

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

Case 04

Theobald Vs Commissioner of Income TAX (TC - Volume I)

Business of growing papaw trees to extract papain-Lease of lands with rent-Agreement to reforest or make permanent cultivation on termination of lease Temporary sheds erected on the land to house the drying ovens and temporary cooly lines to house the labourers - Claim for deduction of expenses incurred - Capital expenditure- Section 10 (c) of Income Tax Ordinance.

The appellant carried on the business of extracting papain from the papaw fruit. For that purpose he took on lease from the Crown and from private parties lands for which he paid no rent. In the case of Crown lands the agreement was to reforest them, but in the case of the private lands the agreement was to plant permanent agricultural plantation such as coconut & c. The lands were leased out free of rent.

For the purpose of extracting papain the appellant had to erect temporary sheds on the land to house the drying ovens and also cooly lines to house the labourers. On the expiration of the lease it was frequently found not worth while dismantling these structures and re-erecting them elsewhere and therefore they were surrendered to the lessors. In the year of assessment in question the appellant expended a sum of Rs. 6,512 on these sheds; he claimed a deduction of one half of this sum as an outgoing or expense.

Held

(1) that the expenditure is incurred for the enduring benefit of the business, not only in relation to the particular land, but also in relation to his business generally, and is made once and for all.

(2) that the expenditure in question is of "a capital nature" within the meaning of section 10 (c) of the Income Tax Ordinance and was not a permissible deduction under section 9.

Case 05

Associated Portland Cement Manufacturing Co. Vs Kerr (27 TC 103)

Sum of money was paid to a retiring director in consideration of a restrictive covenant not to compete with the company. This was held to be an expenditure of capital nature. The payment to the director was an expenditure made once and for all to bring into existences an advantage for enduring benefit of the trade. The advantage was the addition to the goodwill by buying off two potential competitors.

Case 06

Mitchell Vs Noble (11 TC)

Director appointed for life, but in case of one direction, decided to dismiss him, but to avoid publicity injurious to the Co.'s reputation, negotiated and paid him off in full satisfaction of all claims.

Held

To be revenue expenditure - This was not made to secure an actual asset, but to continue as in the past.

Special Note

However, even though this expense was not a capital nature, under the income tax law in Sri Lanka, an expense can be claimable only if it is incurred for the production of income.

That means an expense should be directly relating to the income generating activity of the business and not remotely connected. Accordingly, this expense can not be claimable under the Sri Lankan income tax law since it is remotely connected to the business and not closely connected.

Case 07

Heyley and Co Ltd Vs The Commissioner of Inland Revenue (CTC - Volume III)

Income tax - Loss of monies by burglary - whether deductible from income as "out goings and expenses".

The assessee, a limited liability company carrying on the business of buying and exporting produce, specially rubber, kept considerable sums of money in the office safe. One night the safe was burgled and Rs. 96,075/= was stolen. The assessee's loss was reduced to Rs. 36,150/= by the recovery of Rs. 23,775/= by the Police and a payment of Rs. 36,150/= by way of an ex-gratia payment by the Insurance Company. The assessee claimed the loss under section 9(1) of the Income Tax Ordinance (Cap. 188) as an "outgoing".

It was held: that the word" outgoings" is wide enough to cover losses, which are involuntary outgoings. The outgoings must to "incurred in the production of profits". The assessee's loss was deductible as being incidental to the business.

Special Note

The loss in this case was allowed to be claimed on the following grounds.

(i) What is allowable for income tax computation is not only an expense, even outgoings also. Outgoings include involuntary out going also.

(ii) The outgoing should be incurred for the production of income. In this case the outgoing was allowed since it is incidental to the business.

(iii) The loss represents working capital and not fixed capital and therefore not a capital expenditure.

Case 08

Haughton Tea Company, Limited Vs Commissioner of Income Tax (CTC - Volume I)

Planting of estate with budded rubber - Deterioration caused by use by a previous owner - Expenditure of a capital nature - Permissible deduction-Section 9(1) (c) and 10 (c) of income Tax Ordinance.

The assessee Company purchased Siriniwasa Estate in 1936 and replanted 5 acres with 'budded rubber' in 1936, 139 acres in 1937 and 100 acres in 1938. At first the Commissioner allowed the expenses incurred in replanting as a deduction in computing the profits of the years in question. At a later stage he made an additional assessment after deducting the expenditure incurred in in replanting.

The assessee appealed to the Board of Review against the additional assessmen but the Board held the view that such expenditure was capital expenditure under section. 10 (c) and that it did not come within the 'general words of section 9 (1), It was contended by the Company that the object of the outlay was not to bring the estate into a better condition (i.e.) to effect an improvement but that the programme of replanting was the normal programme of a certain percentage of trees being planted each year. It was also contended by the Commissioner that it was the practice of the Income Tax Department to allow such expenditure as a deduction under section 9 (1) (c) but that in this case the allowance was not admissible to make up to the owner the deterioration caused by its use by a previous owner.
Held

(1) that the replanting took place, not to repair the neglect of years so as to enable the estate to yield a return, but as a precautionary measure inseparable from the running of a rubber estate on business lines and that therefore, the expenditure was a permissible deduction under section 9 (1) [c] of Income Tax Ordinance.

(2) The question of what is capital expenditure is one of fact which must be decided on available date.

It was held that the expenditure involved in replanting in the substitution of an asset subject to waste for another wasting asset, does not effect any improvement in an estate and that it may be regarded as an essential revenue expenditure for the purposes of maintaining a certain requisite level of productive efficiency.

Case 09

Law Shipping Co Ltd Vs CIR (12 TC 621)

Repairs necessary at the time of purchase to render the subject matter of purchase serviceable fall to be added to the initial cost of the assets as the capital charge, and cannot be deducted in computing the profits. In this case, the vessel was not in a state to pass survey at the time of purchase and could not have been used by the purchaser without effecting the repairs.

Case 10

Odeon Associated Theaters Ltd Vs Jones (48 TC 257)

Cost of repairs to four of the company's cinemas which was attributable to wear and tear before they were bought by the company was held to be deductible.

The decision on this case was made on the basis that the expenditure on repairs would be treated according to the principle of sound commercial accounting as revenue expenditure and there was no reason to doubt the accuracy of the treatment. Sir John Pennycuick Vise Chancellor said that one took expenditure as one found it when it was incurred, not spreading artificially over years when it was not incurred. Thus when an asset is brought into use in a trade as an asset which though old was suitable for use in the trade and was for sometime used in that trade but which has to be reconditioned to a state of repair better than it enjoyed when first brought into use. In such circumstances the expenditure is made with a view to enabling the asset to continue to be used in the trade and to earn the profits of the trade, the expenditure will be an expenditure of revenue and not for capital.

Case 11

The National Mutual Life Association of Australasia ltd. Vs Commissioner of Income Tax (CTC - Volume I)

Ascertainment of profits of insurance companies-Contribution to Staff Superannuation Fund-Expenses of Head Office Revenue and capital expenditure-Premia-Section 42 of Income Tax Ordinance.

Held

To be capital nature

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

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For the purpose of extracting papain the appellant had to erect temporary sheds on the land to house the drying ovens and also cooly lines to house the labourers. On the expiration of the lease it was frequently found not worth while dismantling these structures and re-erecting them elsewhere and therefore they were surrendered to the lessors. In the year of assessment in question the appellant expended a sum of Rs. 6,512 on these sheds; he claimed a deduction of one half of this sum as an outgoing or expense.

Held

(1) that the expenditure is incurred for the enduring benefit of the business, not only in relation to the particular land, but also in relation to his business generally, and is made once and for all.

(2) that the expenditure in question is of "a capital nature" within the meaning of section 10 (c) of the Income Tax Ordinance and was not a permissible deduction under section 9.

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Case 06

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Director appointed for life, but in case of one direction, decided to dismiss him, but to avoid publicity injurious to the Co.'s reputation, negotiated and paid him off in full satisfaction of all claims.

Held

To be revenue expenditure - This was not made to secure an actual asset, but to continue as in the past.

Special Note

However, even though this expense was not a capital nature, under the income tax law in Sri Lanka, an expense can be claimable only if it is incurred for the production of income.

That means an expense should be directly relating to the income generating activity of the business and not remotely connected. Accordingly, this expense can not be claimable under the Sri Lankan income tax law since it is remotely connected to the business and not closely connected.

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Case 01

Commissioner of Inland Revenue Vs A.W. Davith Appuhamy (CTC - Volume III)

Litigation expenses- When deductible from profits of a business - Section 9 and 10 of the Income Tax Ordinance (Cap. 188)

The respondent successfully repelled the claims of some associates to have a share in a business called the Kandy Ice. Co. and he claimed deductions in respect of litigation expenses in the computation of profits for the three years ending 31st March, 1953, 31st March, 1954 and 31st March, 1955. The Board of Review upheld the argument for the respondent that the sums in question constituted expenditure incurred in the production of income. The Supreme Court dismissed the present appellant's claim.

It was held; that a business must be considered as a distinct source of income so as to identify the receipts, expenditure and charges attributable to it and as the litigation expenses were in respect of an issue that would not have affected the profits of the business but only the respondent's share they cannot be deducted under section 9 of the Income Tax ordinance as outgoings incurred in the production of income. They are also disallowable under section 10 being monies not expended for the purposes of producing income.

Case 02

Strong Vs Woodifield (5 TC 215)

Any disbursement or expenses which are money not expended for the purpose of producing income cannot be deducted in computing income for tax purposes. The expenses charged must be related to the trade, business profession or vocation and should not be too remote but must be incidental to the relevant activities.

Lord Davy. "It is not enough that the disbursement is made in the course of or arise out of, or is connected with the trade, or made out of the profits of the trade. It must be made for the purpose of earning the profits".

In this case, damages payable for injury he sustained while in the hotel was held to be an expense unconnected with the trade and therefore not deductible. The reasoning was:

Lord Loreburn "... the loss sustained by the appellant was not really incidental to their trade as innkeepers and fell upon them in the character not of as traders, but of householders."

9.0 TRAVELING EXPENSE INCURRED FROM RESIDENCE TO BUSINESS PLACE

Traveling expenses incurred within Sri Lanka by any trade, business, profession or vocation is deductible specifically under section 25 of the Inland Revenue Act No. 10 of 2006.

However, any domestic or private expense is not allowable under section 26 including traveling between residence to place of work.

Case 01

Rajapakse Vs Commissioner of Income Tax (CTC - Volume I)

Deduction for expenses incurred in traveling by advocate - whether claim for traveling from chambers to Courts will come within section 10 (a) of the Income Tax Ordinance - Meaning of the term "place of business" with reference to an advocate-Question of law in case stated under section 74(2).

This was a case stated for the opinion of the Supreme Court under the provisions of section 74 of the Income Tax Ordinance, 1932.

The appellant is an advocate residing at Rosmead Place, Colombo, and practicing before the Supreme Court, at Hultsdorp.

He claimed deduction for the rent of the chambers in his house and the cost of traveling to and from chambers to the Supreme Court, sitting in its appellate capacity at Hulftsdorp.

He was allowed a deduction for the cost of traveling between his chambers and the outstation courts.

The Board of Review held that the deduction claimed was the cost of traveling between the residence and place of business within meaning of section 10 (a) of the Income Tax Ordinance and could not be allowed.

Held

(1) that expenses incurred by an advocate in traveling from the premises in which he resides and has his chambers to the Supreme Court are not costs of traveling between his residence and place of business coming within the meaning of section (10) (a) of the Income Tax Ordinance.

(2) Per Dalton J - that the Supreme Court is not a place of business of an advocate; per Dribeberg J - that the chambers of an advocate and the Courts are the places of business of an advocate; that therefore, his movement from one place of business to another does not come within the scope of section 10 (a)

Special Note

The expenses incurred by an advocated in traveling from the premises in which he resides and has his chambers, to the Supreme Court were held not to constitute traveling expenditure between residence and place of business and therefore were allowable. The chambers of an advocate and courts are the place of business of an advocate and therefore the movements from one place of business to another does not come within the scope of the prohibition.

The appellant carries on a life insurance business, having its Head Office in Melbourne, in the State of Victoria, but it has a branch in Colombo through which it carries on a portion of its life assurance business.

Since 1917 the Company has paid pension to its employees out of its profits and reserves in accordance with a Staff Superannuation Scheme formulated at that time; in 1944 a Staff Superannuation Trust Fund was established by Deed and vested in Trustees. To the establishment of this Fund the Company during the period of assessment made an initial contribution of £ 150,000 being the amount found to be necessary for meeting the obligation under the Deed. This sum was paid in order to get rid of its pension liabilities and to fulfill its promise to its employees. The Company applied to the Commissioner of Income Tax for approval of the Fund so as to have the benefit of section 9(1) (g) of the Income Tax Ordinance but the application was refused. The appellant appealed to the Commissioner that a fair proportion of the sum of £150,000 should be taken into account as Head Office expenses.

It was held by the Board of Review that the Company's claim for approval of the Fund under section 9 (1) (g) was disallowed and therefore the deduction was prohibited under section 10. The question was whether any portion of the said sum of £150,000 is deductible from the appellant's profits for the year of assessment as being expenses of the appellant's Head Office under section 42(1).

Held

(1) that there was an existing liability on the part of the company to pay old age pensions to its employees and that the Company provided a lump sum in order to prevent annual sums having to be paid later and to be able to fulfill its promises to its employees; therefore the payment of the sum would be an ordinary business expense and that under section 42 (1) a fair proportion of the sum was deductible from the company's profits as expenses of the Head Office

(2) that the payment was not made in order to bring into existence a pension fund, and thus bring into existence an existence an advantage for the enduring benefit of the Company as in Atherton's case.

(3) that a payment spent once and for all may be capital expenditure, or may properly be chargeable against revenue expenditure as for instance the purchase of annuity for the benefit of an actuary who was retired.

(4) that it is section 42(1) alone which provide the basis for the ascertainment of the profits of a life insurance business, and that sections 9 and 10 which prescribe the permissible deductions are inapplicable in the case of insurance business.

8.0 PRODUCTION OF INCOME & PURPOSE OF TRADE

8.1 Expenditure must be Incurred

The expenses that could be claimed must be incurred. Thus expense for services obtained but not paid for could be deducted. In the same manner advance payment for expenses cannot be deducted, in that year. Any provisions for likely losses, or liabilities are also not deductible.

8.2 Expenses Incurred in Production of Profits & Income

The expenses that are permitted to be deducted are 'all outgoings and expenses incurred, in the production of income 'and' any disbursements or expenses expended for the purpose of producing such profits and income. In order that expenditure is deducible it will be necessary to establish three criteria.

i. The expenditure must constitute disbursement or expenses, as otherwise no deduction may be permitted.

ii. The purpose of the expenditure must be that it is incurred for the purpose of earning the profits or income.

iii. The disbursement or expenditure must be sufficiently connected with the carrying on and earning the profits of any trade, business, and profession or vocation.

A payment of damages is a loss as is the payment of a fine o penalty. A loss to be deductible must be 'contemplable' and in the nature of a commercial loss. It must be directly connected with and rise from the conduct of the trader's business. A fine line may have to be drawn between what is within what is outside the trader's profits earning activities.

8.3 Purpose of Trade

The expenditure must be for the purpose of producing profits and income.

"... for the purpose of the trade, These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade ... I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade."

Although there is difference in the language, the words' in the production of income' in the Inland Revenue Act which has generally, been considered to be consistent with the word "for the purpose of the trade" in the English Acts.

10.0 REASONS FOR NOT ACCEPTING THE RETURN

10.1 Requirement to Communicate the Reason

Where the assessor rejects a return of income he is bound to give reasons for not accepting the return of income without exception. The provision to give reason is mandatory and the assessor must comply as an assessment made without giving reasons is not a valid assessment and is null and void. The break-down of the provisions requiring the assessor to communicate his reasons are:

(d) "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.

(e) There is next the requirement of making an estimate. This must necessarily be done, otherwise no tax could be collected and the St -- would suffer. There is no doubt that this is mandatory provision. Witho it an imposition of a tax will be illegal.

(f) The third is a requirement to communicate the 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 king. I have no doubt this provision is a mandatory one."

Samarakoon C.J. in Ismail v. CGIR: 4 CTC 156

The provision of the section imposes a duty to communicate the reason but does not impose a time limit within which such reason should be communicated. But the exercise of the process of assessment is not complete until the reasons for not accepting the return have been communicated. The Chief Justice observed that such communication must be made at or about the time the Assessor sends his assessment or an estimated assessment and any later communication will defeat the remedial action intended by the provision.

A duty is imposed on the Assessor not only to give reasons for non-acceptance of a return but also to communicate them to the assessee. The law has been enacted to

(c) prevent arbitrary and grossly unfair assessments and 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

(d) to make known the reason for rejection to the assessee to enable him to demonstrate the untenability of the said reason at the hearing of any appeal that may be preferred against the assessment.

The fact that a return is false does not entitled the Assessor to refrain from giving reasons for the rejection of the return.

"No doubt there may be cases where the reasons for non-acceptance may be obvious but one must bear in mind the fact that the legislature has made no exception to the general rule and the duty cast on the assessor must be carried out even though the assessee himself accept the obvious. I am of opinion that the Assessor is bound o give reason for non-acceptance of a return without exception."

Samarakoon C.J. in Ismail v. Fernando

10.2 Assessor must give Reasons & not Conclusions

The Assessor is required to give his reasons for rejecting return and not his conclusions.

The Assessor informed the taxpayer company "According to the information available with me, the statement of account furnished by you in support of the return of income ..... does not reveal the correct profits". The Court held that the Assessor's statement in the letter is a conclusion and not the reason for the conclusion.

10.3 The Reasons for Rejection of the Return must be Adequate

The taxpayer must fairly understand the reason why the return is rejected.

Case 01

D.M.S. Fernando and Another and Mohideen Ismail, Respondent

Inland Revenue Act Section 96 (3) (d) - Requirement of Statement of reasons in writing such requirement whether Mandatory or Directory - Failure to state reasons - consequence.

The Respondent- Petitioner is a taxpayer who furnished a return for 1975/76. In the return he declared that his income was Rs.88,915/-. However, the Assessor had information that he had done business with B.C.C. and that he had earned a gross sum of Rs. 961,415/-. After many interviews with the Assessor the taxpayer was warned that this return would be issued. The Assessor issued an assessment on 29.4.79 drastically reducing the amount claimed as expenses. The taxpayer appealed against this assessment to the Assessor.

In the meantime the Taxpayer applied to the Court of Appeal for a Write to quash the assessment on the grounds that the Assessor had not given his reasons in writing for rejecting the return. The Court of Appeal granted the writ but the appellants appealed against the order.

Held

(Sharvananda, J.& Wimalaratne. J, dissenting) The notice of assessment was null and void because the Assessor failed to obey a mandatory order to give his reasons in writing to the taxpayer for rejection of the return in terms of section 90C (3) (d) of the Inland Revenue Act. It is 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 amendent.

Case 02

New Portman Ltd and W. Jayewardene and Others

Section 115 (3) - No Reason stated for NON Acceptance of Return of assessee

Where the assessor purporting to Act under section 115 (3) informed the assessee "according to information available the statement of accounts furnished by you..... Does not reveal the correct profits".

Held

This was only a conclusion and not the reason for the conclusion. It therefore does not satisfy the requirements of under section 115 (3) proviso. The re given must be intelligible and deal with the substantial points that have been raised.

Further, the assessor in rejecting the return had acted on "information available". He must communicate to the assessee the substance of information to such an extent as to put the assessee in possession of full particulars regarding the case he is expected to meet and should give time and opportunity to meet it if possible. It is not necessary to disclose to assessee the source of the information.

11.0 PLANT

11.1 Meaning of Plant, Machinery of Fixtures

The word 'plant' and 'machinery' has not been defined in the Act. The word plant has wider meaning and has found some judicial definitions. It is usually possible to decide whether or not an item is machinery and if difficult to identify what is plant. The words plant and machinery have meanings independent of each other. A building is not a plant but may in some circumstances have the functions of a plant. A building housing plant, machinery or fixtures may be part of the building or may be functionally separable: the cost of a building may have significant cost of plant, machinery or fixtures. It is useful to identify what is plant, machinery or fixtures on account of the significant tax relief by way of capital allowance, deductible in ascertaining the profits and income.

11.2 What is Plant?

A definition of plant, which has been expounded by Lindlay L.J. in the case of Yarmouth v. France: 19 KBD 747, has been received with approval by the House

of Lords as an accurate description of plant for income tax purposes in the case of Hinton v. Maden & Ireland Ltd: 39 TC 391.

"Plant in its ordinary sense, includes whatever apparatus is used by a businessman for carrying on his business, not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed and movable, live or dead which he keeps for permanent employment in his business."

Commenting on this definition of plant, Oliver L.J. in Cole Brothers Ltd: v. Phillips: 57 TC 188: identified three essential qualities or principles being present before an item can be considered plant.

"The proposition imports three essential qualifications for any given subject-matter before it can be considered plant, viz (i) it must be an 'apparatus' ; (ii) it must be used for the carrying on of a business; and (iii) it must be kept for permanent use in the business.

11.3 The Structure and the Functional Test

In order to decide the difficult question of what is plant the courts have been guided by the test whether the object described as plant performs any operation or a function or that the object is part of the setting in which the trade or business is carried on. Where it is found that the object is an apparatus or performs or performs or fulfils a function it will be considered plant. And where that part of the structure or object is the setting in which the business is carried on, then such structure or object cannot be plant.

"The conjunction of "machinery" and "plant" ....suggests to me that they must both perform some active function. In order to decide whether a particular subject is an "apparatus", it seems obvious that an inquiry has to be made as to what operations it performs. The functional test, therefore, essential at any rate as a preliminary."

Lord Guest in Barclay Curle & Co. Ltd. Vs IRC: 45 (TC 221)

In this case, the House of Lords held that the cost of excavations and the construction of the concern walls and floor of the dry dock including the cost of providing pumps and machinery qualified as plant. The reasoning was:

"The only reason why a structure should also be plant... is that it fulfils the function of plant in the readers operation. And, if that is so, no test has been suggested to distinguish one structure, which fulfils such a function from another. I do not say that every structure, which fulfils the function of plant, must be regarded as plant, but I think one would have to fing some good reason for excluding such a structure. And I do not think that mere size is sufficient.

11.4 Premises, Structure, Setting in which Trade or Business is carried on

An item can be part of the setting in which the business is carried on without forming part of the premises that can be considered plant. The nature of the trade carried on and the relationship of the expenditure for the promotion of that trade can be important. Thus in the case of IRC v. Scottish and Newcastle

Breweris: 55TC 252, light fitting, décor, and [illegible]rals were considered plant and not part of the setting and qualified for capital allowances.

"It seems to me, on the Commissioners findings, which are clear and emphatic, that the taxpayer company's trade includes, and is intended to be furthered by, the provision of what may be called 'atmosphere' or 'ambience', which (rightly or wrongly) they think may attract customers. Such intangibles may in a very real and concrete sense is part of what the trader sets out, and spends money, to achieve. A good example might be a private clinic or hospital where quiet and seclusion are provided, and charged accordingly. One can well apply the 'setting' test to these situations. The amenities and decorations I such a case as the present are not, by contrast with the Lyons case, the setting in which the trader carries on his business, but the setting which he offers to his customers for them to resort to and enjoy. That it is setting in the latter and not the former sense for which the money was spent is proved beyond doubt by the Commissioners findings".

Lord Wilberforce in IRC v. Scottish and Newcastle Breweries Ltd: 55 TC 252

11.5 Building or Structures where Trade or Business is carried on

To qualify as plant a structure or building must be the "means by which" or the "plant with which" the business activities are carried on.

"It plainly appears, therefore, that if, and only if, land, premises or structures in addition to their primary purpose perform the function of plant, in that they are the means by which a trading operations is carried out, then for the purpose of income tax and corporation tax the land, premises or structures are treated as plant".

Templeman L.J. in Benson Vs Yard Arm Club Ltd: 53 (TC 67)

The expenditure on the conversion of a ship into a floating restaurant did not qualify as plant for capital allowances. The reasoning for the decision was:

"The business of the company is that of restaurateurs, that is to say the preparation and service of meals to the public..... it is disputed that if such a business were carried on in the normal way in a building attached to the soil, the building would not constitute plant: it would be no more than the structure within which the business is carried on.....No doubt, the fact that this restaurant is situated on the river is an attraction to patrons, and that it has the appearance of being a ship may also be an attractive feature.....But these features do not differ in qualify from the advantage of having a restaurant in a building on dry land, which enjoys an attract custom, they play no part in the conducting of the business."

11.6 Electrical Installations may Constitute Plant

"It may well be that a building is incomplete without some form of electrical installation, but if the occupier in supplying that deficiency installs a system specially adopted to the particular business purpose for which he proposes to use the building - a purpose, for instance, requiring particularly heavy cables

because of the current likely to be consumed or a particular process - I do not see why the mere fact that is removal would render the building incomplete should deprive it of its character as plant.

Oliver L.J. in Cole Broz. Ltd. Vs Phillips: 55 TC 188

In this case the Revenue contended that where the building would be incomplete without the apparatus, that apparatus would not be plant.

It was contended by the taxpayer that a car-washing facility in which cars washed in conveyer belt system where the entirety of the site constitute a single entity was, in itself, a single item of plant was rejected: Atwood v. Anduff Car Wash Ltd: [1996] STC 110. The court held that the mere fact that a building in which a business was carried on was by its construction particularly well suited to the business or indeed was specially built for that purpose did not make it plant. The site on which the car-wash business was opened, and the building in which the machinery was housed, constitute premises and they performed typical premises function.

11.7 Building acquired by a Company and let for Commercial Purposes

A Company carrying on the business of letting premises for commercial purposes is not entitled to claim depreciation allowance on the building acquired. A building acquired in a business of letting premises for commercial purposes cannot be considered as a plant. The eligibility for depreciation is in respect of qualified building constructed and used in such business.

Case 01

Thornhill Vs Commissioner of Income Tax (CTC - Volume I)

Income Tax - Tea Factory - Depreciation by wear and tear - outgoings and expenses - Deductions - Meaning of word "plant" - Allowance in respect of repair and renewal - Section 9 (1) (a), (1) (c) and 10 (c) of Income Tax Ordinance.

The appellant was a tea planter who converted his own green leaf into tea in his own estate. He carried on this business of his in a tea factory. He claimed an allowance of Rs. 8,893/- being the amount of depreciation in the value of the tea factory on his tea estate which was essentially used for the purposes of his "business". It was contended that the deduction was allowable under section 9(1) (a) being depreciation by "wear an tear of plant & c." or alternatively as an "outgoing" or "expense" incurred in the production of "income" under Section 9 (1).

Held

(1) that the word "Plant" cannot be made to include the building or shell which contains any plant.

(2) In ascertaining the income of a person from a tea estate, no allowance can be made for deprecation by wear and tear by natural decay in respect of a tea factory building employed in producing the income.

(3) But allowance may be made under Section 9 (1) (c) on account of repair and renewal necessitated by constant use for the purposes.

Case 02

Chelvanayakam Vs Commissioner of Income Tax

Income Tax - Advocate's purpose of Law Reports - Deduction of cost - Section 9 (1) (a) of Income Tax Ordinance.
The assessee-appellant, who is an advocate purchased a number of volumes of the Indian Appeal Law Reports and expended a sum of Rs. 354. He claimed that sum must be deducted for the purpose of arriving at his at his taxable income. This claim was disallowed by the Commissioner and the Board of Review.

Held

(1) that the cost of a set of Law reports purchased by an advocate in not a permissible deduction as an "Outgoing and expense under section 9 (1) (a) of the Income Tax Ordinance.

(2) that the books which a lawyer consults on his shelves could not be included in the expression "plant and machinery"