RODRIGO
v.
THE COMMISSIONER-GENERAL OF INLAND REVENUE

SUPREME COURT
SARATH N. SILVA, CJ.,
BANDARANAYAKE, J. AND
ISMAIL, J.
SC APPEAL NO. 3/2000
CA NO. 1/96
JANUARY 08, 2002
MARCH 07 AND 22, 2002
APRIL 04, 2002

Income tax – Partner of a firm providing auditing services and tax advice to local and foreign clients – Remuneration earned in such service in foreign exchange and local currency – Exemption of foreign currency from tax – Section 15 (ccc) of the Inland Revenue Act – Outgoings and expenses incurred in producing the foreign income – Section 23 (1) of the Act – Whether the Assessor in entitled to disallow the expenses relating to foreign exchange earnings calculated on a pro rata basis between fees received in foreign and local currency.

Held:

(1) The appellant's firm has only one indivisible business, the common exercise of it being providing services to local and foreign clients with professional skills of the partners and the staff.

(2) Where an assessee carries on an indivisible business and a part of its profits is not liable to tax, the entire expense for the purpose of the business should be allowed although a part of the expenses may have been incurred for earning the non-taxable profits.

(3) The assessor was not entitled to make deduction from the expenses on outgoings made on a *pro rata* basis computed on the ratio of earnings in local currency as to earnings in foreign currency.

Cases referred to :

1. *Sub Nigel v. CIR* – (1948) 4 SA 580, 15 SATC 381.
2. *Hayley and Company Ltd v. Commissioner of Inland Revenue* – (1961) 65 NLR 174.
3. *Port Elizabeth Electric Tramways Company Ltd v. CIR* – (1936) CPD 241, 8 S.A.T.C. 13.

APPEAL from the judgment of the Court of Appeal.

Shibly Aziz, PC with *Mano Devasagayam* and *Nadana Civa* for appellant.

L. M. K. Arulananthan, Deputy Solicitor-General with *Suren de Silva*, State Counsel for respondent.

Cur. adv. vult.

August 02, 2002

SHIRANI A. BANDARANAYAKE, J.

This is an appeal from the judgment of the Court of Appeal dated 22. 10. 1999. 1

The assessee-appellant-petitioner-appellant (hereinafter referred to as the appellant) was, at the time material to this case, a partner of the firm of Coopers and Lybrand Associates, now known as Price Waterhouse Coopers, which is based in Sri Lanka. In the assessment year 1991-92, the firm, where appellant was a partner, in the course of the professional practice carried on or exercised by it, rendered services in Sri Lanka for clients overseas who remitted fees in foreign currency to Sri Lanka totalling a Rupee equivalent of Rupees 15,196,674. 10 Along with the local currency earned by the firm, which amounted to Rupees 12,151,367, it had gross receipts amounting to Rupees 27,348,041. In the returns furnished by the partnership it claimed a sum of Rupees 21,798,656 as total expenditure which sum included

the sum of Rupees 5 million paid to other accountancy bodies who were sub contractors supplying services in the business, which earned foreign currency for the partnership.

The partnership in its said returns claimed a divisible loss of Rupees 9,325,001. This was based on the difference between the locally earned income, which is liable to income tax and the total expenditure incurred in earning the gross receipts. Out of this sum of Rupees 9,325,001, a sum of Rupees 2,797,500 was allocated as the appellant's share of loss.

The Assessor in a communication to the appellant under section 115 (3) of the Inland Revenue Act, No. 28 of 1979 (hereinafter referred to as the Act) rejected the return made by the appellant claiming a loss of Rupees 2,797,500 and computed the divisible profit of the partnership at Rupees 2,436,878 of which the appellant's share of the profit was Rupees 731,063. The Assessor did not question the exclusion of the emoluments received in foreign exchange from the computation of the partnership's profit and loss, but sought to disallow the expenses relating to the foreign exchange earnings calculated on a *pro rata* basis between fees received in foreign and local currency.

The appellant appealed against the said assessment to the respondent-respondent (hereinafter referred to as the respondent) and the respondent without hearing the appeal referred the matter to the Board of Review. The Board of Review held against the appellant and confirmed the assessment made on the appellant by its order – dated 14. 12. 1994 (P1). The appellant being aggrieved by the said order, made an application to the said Board under section 122 (1) of the Act requesting the Board to state a case on a question of law for the opinion of the Court of Appeal. Two questions of law that were in the following terms came up before the Court of Appeal:

(1) Is the sum of fees amounting to Rupees 15,196,674 earned in the year of assessment 1991/92 by the partnership known

as Coopers and Lybrand Associates, in foreign currency through the rendering of services in Sri Lanka to clients overseas and remitted to Sri Lanka, exempt from income tax under section 15 (*ccc*) of the Inland Revenue Act, No. 28 of 1979?

(2) If the answer to the said question is in the affirmative, was the assessor justified in his opinion that in computing the divisible profits from the business carried on by the partnership, no deduction could be allowed for the expenses incurred on the earning of the fees exempt from income tax under section 15 (*ccc*) of the Inland Revenue Act, No. 28 of 1979?

The Court of Appeal by its order dated 22. 10. 1999 answered both questions in the affirmative and dismissed the appellant's appeal.

The appellant appealed to this Court and the Court by its order dated 07. 02. 2002 granted special leave to appeal.

The Act prescribes a step by step process wherein exemptions and deductions are permitted when computing the taxable income. To arrive at the taxable income consideration should be given only to the permissible deductions provided by the Act and the Court cannot take into consideration any other means of computing the deductible amounts. As pointed out by Centlivers, CJ., in *Sub Nigel Ltd. v. CIR.*[1] :

"The Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act."

It is common ground that the partnership to which the appellant belonged to earned money in local as well as in foreign currency. Section 15 (*ccc*) of the Act, provides that emoluments and fees earned in any year of assessment in foreign currency by a partnership in Sri Lanka shall be exempt from income tax. The respondent accepted

the exemption of appellant's earnings in foreign currency. However, based on the above exemption, the respondent contented that only a proportionate amount of outgoings should be deducted in terms of section 23 (1) of the Act. The appellant took up the position that the said outgoings referred to by the respondent relate to one source of income in terms of section 3 (*a*) of the Act and according to the provisions of section 23 (1), the entirety of that amount should be deducted.

The partnership to which the appellant belonged to carried on or exercised a professional practice in Sri Lanka dealing with local as well as foreign clients. From its inception, the appellant's firm carried on or exercised the said professional practice as a single indivisible business organization under the control of the partners. A core staff of specialists supported the firm in rendering the relevant professional service. The partners as well as the staff and the physical assets of the organization were not divided to serve local clients and foreign clients separately. Accordingly, the firm has only one **indivisible business,** the common exercise of it being providing services to local and foreign clients using the professional skills of the partners and the staff.

Section 3 of the Act refers to the income chargeable with tax and subsection (*a*) refers to the profits from a profession. Section 3 (*a*) of the Act reads as follows:

> "For the purposes of this Act, "profits and income" or "profits" or "income" means –
>
> (*a*) the profits from any trade, business, profession or vocation for however short a period carried on or exercised;"

In terms of section 3 (*a*), the appellant had earned profits in local and foreign currency by carrying out professional services. Although earnings have been made in local as well as in foreign currency, the

appellant was involved only in one professional activity, viz as auditors renderding services of auditing and providing management and tax advice. This does not amount to duality of professional activities, but only sub sources within one main line of professional activity. Hence, there is only one source of income in terms of section 3 (*a*) of the Act.

Section 15 (*ccc*) of the Act refers to the exemption from income tax, emoluments and fees earned in any year of assessment in foreign currency by any resident individual or a partnership in Sri Lanka. The appellant's firm being a partnership, which earned certain fees in foreign currency, would thus become entitled for this exemption.

Chapter IV of the Act spells out the provisions pertaining to the ascertainment of profits and income. Section 23 of the Act refers to the deductions allowed in ascertaining profits and income whereas section 24 deals with deductions which are not allowed in ascertaining profits and income.

Section 23 (1) of the Act is in the following terms:

". . . there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof, including . . ."

Section 23 (1) refers to 3 important elements in connection with the "ascertainment of the profits or income of any person",

(*a*) the sources of profits or income of any person;
(*b*) all outgoings and expenses incurred;
(*c*) that such outgoings and expenses should be incurred in the production of such income.

It is obvious that section 23 focuses on all aspects of expenses as it refers not only to "expenses", but also to the "outgoings". The word "outgoings" gives a wider meaning than the word "expense". "Outgoings" incurred by a person carrying out a profession, could include a wide variety of items, which would not come within the meaning of "expenses". Basnayake, CJ. in *Hayley and Company Ltd.* v. *Commissioner of Inland Revenue*[2] considered the two phrases referred to above which formed section 9 (1) of the former Income Tax Ordinance. Section 9 (1) is similar to section 23 (1) of our current Act. He observed that:

> "The word "outgoings" means what goes out and is a word of wide import. It is the opposite of the equally wide expression "income", which means what comes in. In the context the word "expenses" is limited by the words "incurred by such person in the production thereof" while the word "outgoings" is not so limited. The two words are designed to express two different concepts, one of wider import than the other. All outgoings are not expenses incurred in the production of the profit or income; but all expenses incurred in the production of the profits or income are outgoings. . ."

On the other hand, in addition to the outgoings a taxpayer would also rely on the expenses that incurred in the production of the income to be claimed as deductions. The meaning of the phrase "incurred in the production of the income" was considered in the South African case of *Port Elizabeth Electric Tramways Company Ltd.* v. *CIR*[3] where, Watermeyer, AJP was of the view that –

> ". . . the purpose of the Act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible . . .
>
> The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here in my opinion, all expenses attached to the

performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation, provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

Section 119 (*a*) of the South African Income Tax Act is similar to section 23 (1) of our Act and reads as follows:

"Expenditure . . . incurred in the production of the income."

The next as well as the more important question that arises for consideration is that, if there is only one source of income out of one indivisible professional activity, whether it is possible for the respondent to cut up the expenses incurred by the appellant's firm in carrying out the said profession.

The respondent's argument is that, the appellant should show the expenses that were incurred in earning the taxable income and only those expenses could be allowed as a deduction in terms of section 23 (1). In support of this argument respondent relies on section 24 (1) (*g*) of the Act. This section states that disbursements or expenses, not expended for the purpose of producing the profits and income will not be allowed as deductions.

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

In considering the applicability of sections 23 and 24, the respondent took up the position that section 24 (1) (*g*) could be applied to disallow amounts expended for the purpose of producing profits and income from the exempt receipts of a source. Section 24 (1) (*g*) is in the following terms:

> "For the purpose of ascertaining the profits or income of any person from any source no deduction shall be allowed in respect of any disbursements or expenses of such person not being money expended for the purpose of producing such profits and income."

Section 24 (1) (*g*) read with section 23 (1) of the Act, show that –

(*a*) any disbursement or expenses which was not spent for the purpose of production of profits and income cannot be deducted;

(*b*) all outgoings and expenses incurred by a person in the production of income from any source could be included as deductions.

Taking both these sections together in their literal context, it appears that the meaning of words in section 23 (1) is restricted by the words given in section 24 (1) (*g*) of the Act. Section 24 (1) (*g*), which spells out the negative or what should not be deducted, uses the words "disbursement or expenses" whereas section 23 (1), which is the positive or the permissible section refers to the words "all outgoings and expenses incurred". The Dictionary meaning of the word "disbursement" explains it as "expenditure" (*The Oxford English Dictionary*, 2nd edition, volume 4, p. 726) which has a limited meaning than the word "outgoing". If I may repeat Chief Justice Basnayake's reasoning in the *Hayley's* case (*supra*) :

"All outgoings are not expenses incurred in the production of the profits or income; but all expenses incurred in the production of the profits or income are outgoings . . ."

Considering this question in a more realistic way, it would not be feasible to distinguish the expenses incurred in the process of carrying out professional services from the perspective of whether the earnings are in local or foreign currency. The usage of office space, equipment, personnel and the payments of bills would have been on a common basis for both local and foreign clients. In such a situation it would not be possible to indicate the actual costs that were incurred in earning income in local and foreign currency.

The important question that comes up at this juncture is whether it is feasible to cut up the expenses incurred in the production of income. Although section 24 refers to the deductions it does not envisage a situation where there would be a need to divide the expenses incurred in the production of the income. Admittedly, there are no similarities between the Indian Tax Act and our Act. However, that does not bar us from considering an established principle, which has been accepted by the Indian Courts. Thus, Kanga and Palkhivala in *Law and Practice of Income Tax* (volume 1, 8th edition, 1990, p. 482) refers to the above situation in the following terms:

"Where an assessee carries on an indivisible business and a part of its profits is not liable to tax, the entire expenditure incurred for the purpose of the business should be allowed, although a part of the expense may have been incurred for earning the non-taxable profits."

In the light of the above, I am of the view that, positioned in a situation as appellant is, where there are two limbs within one source of income, the respondents are not empowered to "cut up" the expenses on a *pro rata* basis, to make the appellant liable for the expenses incurred for earning the non-taxable profits. Accordingly, when the

respondent quite rightly exempted the appellant's income earned in foreign currency in terms of section 15 (*ccc*) of the Act, the respondent had no authority to cut up the expenses incurred in carrying on the business of a partnership during the relevant year and disallow such part on a *pro rata* basis as it should be attributed to the earning of the exempted fees.

However, it would be necessary to give a meaning to the words in section 24 (1) (*g*) of the Act. If any part of the expenses could be clearly identified as having being expended for the purpose of deriving money not being profits or income liable to tax, such amount could not be deducted in terms of section 24 (1) (*g*). Specific expenses relating to the earning of exempt income are given as an example for such a situation. In fact, the appellant agreed that the following amounts, being direct expenses relating to the earning of exempt income, would have to be disallowed.

Subcontracted expenses on plantation restructuring	- Rs.	5,507,735
Turnover tax payable on exempt fees	- Rs.	759,833
Consultants fees related to exempt fees	- Rs.	500,000
Total	- Rs.	6,767,568

In the circumstances, while the Court of Appeal was quite rightly of the view that the fees earned in foreign currency are entitled to be exempted without any deductions for the expenses attributable to the earning thereof, the Court of Appeal was not justified in its conclusion that such expenses could be disallowed in computing the divisible profits of the partnership. Thus, the answer to the 2nd question, which was before the Court of Appeal, should have been in the negative.

In summing-up it would be useful to reiterate the following:

The appellant's firm has only one indivisible business. There was only one source of income with a sub source, where the earnings were in foreign currency. It is apparent that the business or profession carried out by the appellant's firm was a single activity and the services rendered and the facilities used for such services could not be divided into two separate categories. The earnings in foreign currency were exempted from income tax in terms of section 15 (*ccc*) of the Act. The other earnings were taxable. With regard to the ascertainment of profits and income from any source, deductions are allowed in terms of section 23 (1) of the Act in respect of outgoings and expenses that are incurred. However, in terms of section 24 (1) (*g*) of the Act, money, which was not expended for the purpose of producing the income not liable to tax cannot be deducted.

Therefore, the two questions framed by the Board of Review, which are mentioned earlier, are answered as follows:

The first question relates to the deductions in respect of the foreign currency earned in terms of section 15 (*ccc*) of the Act which has been answered correctly by the Court of Appeal. The second question relates to the deductions from the expenses on outgoings made on a *pro rata* basis computed on the ratio of the earnings in local currency as to the earnings in foreign currency. The Court of Appeal had erred in answering this in the affirmative. Sections 23 (1) and 24 (1) (*g*) do not permit such deductions for outgoings to be made on a *pro rata* basis.

For the aforementioned reasons, the appeal is allowed and the judgment of the Court of Appeal dated 22. 10. 1999 is set aside with costs.

SARATH N. SILVA, CJ. – I agree.

ISMAIL, J. – I agree.

Appeal allowed.