1935 *Present :* **Akbar S.P.J. and Maartensz J.**

THE COMMISSIONER OF INCOME TAX *v.* R.M. A.R. A.R. R.M. ARUNACHALAM CHETTIAR.

D. C. (Inty.) Colombo, 24.

Income Tax—Unpaid interest due for the period of assessment—Recoverable loans—Income Tax Ordinance, No. 2 of 1932, ss. 6, 9 (1).

A money-lender may be assessed for Income Tax in respect of unpaid interest on recoverable loans which fell due during the period for which profits are ascertained.

THIS was a case stated by the Board of Review under section 74 of the Income Tax Ordinance on the application of the Commissioner of Income Tax.

The respondent was a firm carrying on the business of money-lending in Ceylon, and his income was assessed for the year 1932-1933 at Rs. 79,830. It included a sum of Rs. 32,000 which was a fair estimate of the unpaid interest which fell due on recoverable loans during the year preceding the year of assessment. The question referred to the Supreme Court was whether in law the assessment should be reduced by Rs. 32,000.

M. W. H. de Silva, Acting S.-G. (with him *Basnayake, C.C.*), for Commissioner of Income Tax, the appellant.—The Board of Review is wrong in disregarding section 47 (re-enacted as sub-section (3), section 9). Income Tax on income which accrues by way of interest was not levied in India; but later, by an amendment of the law in 1922, tax is to be levied (assessed) in India according to the system of bookkeeping resorted to by individual taxpayers. Our view point is a different one, and no assistance can be obtained through Indian cases.

Two things are taxed in Ceylon:—(1) Profits, and (2) Income; and not merely income. Profits are not received; they are *made*. Income is *received*. Profits are liable to be taxed whether they come in or not.

By section 9 (1) (*d*) of our Ordinance, provision is made for allowances for bad debts; this connotes the existence of good debts. If there is a discretion to allow deductions for bad debts, there should be a similar discretion to include good debts in profits. In England, in assessing the profits of a business, one has to take into consideration debts, good as well as bad. See *Scottish Mortgage Company of New Mexico v. Surveyor of Taxes*[1], where it was held the Crown had the right to tax under that heading most favourable to the revenue.

It is well settled that it is for the Crown to choose in which capacity the tax is to be charged. See *Liverpool and London Globe Insurance Company v. Bennett*[2] and *The Rosyth Building and Estates Co., Ltd. v. P. Rogers (Surveyor of Taxes)*[3].

A practice of the revenue authorities not warranted by statute cannot be upheld in a Court of law—see judgment of the Privy Council in *Gleaner Company Ltd. v. Assessment Committee*[4]. Therefore, in this case it was open to the Commissioner to assess on the basis of profits of a business or of an investment. In his own interest, the Commissioner has

[1] *2 Tax Cases 165.*
[2] *6 Tax Cases 327.*
[3] *8 Tax Cases 11 at p. 15.*
[4] *(1922) 2 A. C. 169 at 175.*

assessed the respondent as on an investment. If it was necessary, the Commissioner would have been justified in calling in aid section 9, sub-section (3). But it was not necessary.

The profits are to be determined in the ordinary commercial way. See *Gresham Life Assurance Society v. Styles*[1]. For meaning of "profits", see *In re the Spanish Prospecting Company Ltd.*[2]

If the assessee's own system of accounts is accepted as the basis of assessment, then assessee may possibly so adjust his accounts as to evade liability to pay any tax whatever.

There is no power in England to make a contingent assessment; with us there is provision to defer collection of the tax, after assessment has been made.

Counsel also cited *2 Tax Cases 437, 441; 3 Tax Cases 189; 5 Tax Cases 221 at 223, 491; 12 Tax Cases 282, 338, 382, 740, 780, 813 at 823, 1027; 13 Tax Cases 874; 15 Tax Cases 613 at 620; 16 Tax Cases 414; 17 Tax Cases 325 at 332; Dowell on Income Tax;* and *Hall & Company v. Commissioners of Inland Revenue*[3].

H. V. Perera (with him *N. Nadarajah* and *Aiyer*), for assessee, respondent.—If the new section 47 does apply, the contention of the Crown cannot prevail.

Income Tax law does not compel persons to keep their accounts in any particular way. The assessee may include a debt, and ask for relief; or he may exclude it. The Chettiars keep heir accounts on what is known as a cash basis. There is nothing sacrosanct in any particular way in which mercantile men keep accounts.

We are only concerned with the question whether the word "profits" in section 6 (1) (*a*) means income. The meaning would be what is usually regarded as profits in the particular vocation or business or employment. The word "income" or the word "profits" ordinarily implies money that has come in, and does not include debts or choses in action. Both words *connote* the same thing. The primary meaning of the word "profits" must be given to the word in the Ordinance.

Section 9 (1) (*d*) cannot apply in the case of persons who keep accounts on a cash basis. It applies only in the case of those persons who had adopted the system of accounting which brought in debts. See the case of the *Secretary to Board of Revenue, Income Tax, Madras v. Arunachalam Chettiar*[4].

The reason why in certain businesses unrealized debts are regarded as profits is because of a certainty of realization.

Section 9, sub-section (3), does not apply. It applies only to a source of income falling under section 6 (1) (*e*), not to one falling under section 6 (1) (*a*). Cf. the argument of the Solicitor-General in 35 N. L. R. 291 at p. 292; and section 21 of Ordinance No. 27 of 1934, which replaces section 47 of Ordinance No. 2 of 1932.

Where the categories are mutually exclusive, then there is no Crown option.

Section 9, sub-section (3), was always understood to apply only to investments. In this case we have been assessed on the footing of an

[1] *2 Tax Cases 633.*
[2] *(1911) 1 Ch. 92 at 98.*
[3] *(1921) 3 K. B. 152.*
[4] *I. L. R. 44, Mad. 65; 1 I. T. C. 75.*

income coming under section 6 (1) (*a*). When that is so, the effect of the new section 47 is to make section 9 (3) inapplicable.

Counsel also cited *17 Tax Cases 325 at 329* (*per Lord Clyde*); *Tennent v. Smith* [1] (*per Lord Halsbury*) : "Income Tax is primarily a tax on (your) income; but presumption may be rebutted"; *London County Council v. Attorney-General* [2] : "Income Tax is one tax; it is not a collection of taxes; there is no difference in kind"; *Lambe v. Inland Revenue Commissioner* [3], *St. Lucia Estate Company v. Colonial Treasurer* [4].

Cur. adv. vult.

November 11, 1935. AKBAR S.P.J.—

This is a case stated by the Board of Review on the application of the Commissioner of Income Tax under section 74 of the Income Tax Ordinance for determination by this Court. The assessee is a firm carrying on a business in Ceylon mainly of money-lending, and, for the year 1932-1933 the respondent's income was assessed at Rs. 79,830 including a sum of Rs. 32,000 which is the subject-matter of the dispute arising in this case. It was agreed between the parties that this sum of Rs. 32,000 would be a fair estimate of the unpaid interest which fell due for payment during the year preceding the year of assessment on recoverable loans, *i.e.*, of interest regarding the recovery of which there could be no reasonable doubt. There was an appeal to the Board of Review from the Commissioner's assessment and the Board of Review allowed the appeal of the respondent and reduced the assessment of Rs. 79,380 by deleting therefrom the amount of Rs. 32,000. The question referred to us for decision is whether in law the assessment should be reduced by the sum of Rs. 32,000, which was admitted by both parties as a correct estimate of the amount of interest which had become due (although it had remained unpaid) during the year preceding the year of assessment on good loans, and which interest the respondent was certain could be collected ultimately, as such interest had become due in the course of the money-lending business carried on by the assessee.

It will be noticed that the case stated mentions the fact that the assessee carries on a business in Ceylon "mainly of money-lending". It was admitted at the hearing before us that the assessee also carries on a business in rice in addition to his main business of money-lendng. Under section 5 (1) of the Income Tax Ordinance, 1932, as amended by Ordinances No. 7 of 1932, No. 21 of 1932, and No. 27 of 1934 (referred to in this judgment as the Income Tax Ordinance) an income tax is charged in respect of the profits and income of every person resident in Ceylon or arising in or derived from Ceylon, in the case of every other person. By sub-section (2) of that section the term "profits and income arising in or derived from Ceylon", includes, without in any way limiting the meaning of the term, "all profits and income . . . . derived from services rendered in Ceylon, or from property in Ceylon, or from business transacted in Ceylon whether directly or through an agent". Section 6 defines the expression "profits and income" for the purposes of the Ordinance under eight sub-heads; 6 (1) (*a*) specifying the profits from

[1] (*1892*) *A. C. 150.*
[2] (*1901*) *A. C. 26 at p. 35.*
[3] (*1934*) *1 K. B. 178.*
[4] (*1924*) *A. C. 508.*

any trade, business, profession, or vocation for however short a period carried on or exercised; (6) (1) (*e*) referring to dividens, interest, or discounts; and the last sub-head 6 (1) (*h*) referring to income from any other source whatever not including profits of a casual and non-recurring nature.

Chapter III. deals with the ascertainment of profits or income and section 9 enumerates what shall be deducted for the purpose of ascertaining the profits or income. Section 9 (1) starts with the qualification that subject to sub-sections (2) and (3) all outgoings and expenses incurred by a person in the production of the profits or income are to be deducted. The section states that the outgoings and expenses are to include outgoings and expenses falling into seven categories which are set forth in sub-heads. Sub-head (*d*) of section 9 (1) allows a deduction of such sum as the Commissioner in his discretion considers reasonable for bad debts incurred in any trade, business, profession, vocation, or employment which have become bad during the period of which the profits are being ascertained, and for doubtful debts to the extent that they are estimated to have become bad during the said period, notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said period. The proviso to this sub-head states that all sums recovered during the said period on account of amounts previously written off or allowed in respect of bad or doubtful debts are to be treated for the purposes of the Ordinance as receipts of the trade, business, &c., for that period. I have quoted this sub-head 9 (1) (*d*) *in extenso* for the simple reason that the words of that clause strongly support the view of the Commissioner of Income Tax. The sub-head expressly refers to profits in the expression " during the period of which the profits are being ascertained ".

The Solicitor-General's argument is that if in the calculation of the profits the Commissioner is given a discretion to allow bad debts to be written off and to allow a reasonable sum to be fixed by him to be deducted from the profits in respect of doubtful debts, it stands to reason that good debts must be included in the calculation of profits so long as they become due and payable during the period of which the profits are being ascertained. Mr. Perera argued that that sub-head only applied in the case of those persons who carried on a trade or business who had adopted the system of accounting which brought in debts and that it did not apply to those persons who carried on a trade or business who kept the system of accounting which only took into account actual receipts of cash, which he called accounting on the cash basis. That is to say, according to Mr. Perera's argument the income tax was to depend on the choice of the assessee in regard to the method of accounting. His argument went even further. Whatever system of accounting is adopted by the assessee, his books must show the outstanding debts due to him, but if he keeps one book or draws up a balance sheet in which only the receipts are shown, for purposes of the income tax it is this book or balance sheet which is to be taken as the basis of the calculation of the income tax and it is this system which is to be called the keeping of accounts on the cash basis.

The law seems to be clear that the assessment must be made and the income tax levied on principles to be deduced from the words of the Income Tax Ordinance whenever a question arises in and is submitted to a Court of law for decision. In other words the Crown is not bound by the particular system of accounting adopted by the assessee (*5 Tax 491; 12 Tax 740 and 882*). If, for purposes of practical convenience, the assessing officer agrees to accept the system of accounting adopted by the assessee for purposes of calculating the income tax, that is a matter which only concerns him and the assessee so long as matters arising therefrom are not referred for arbitration to the law Courts. What a law Court is concerned with is the interpretation of the law so far as it exists and affects the points submitted for decision.

In *Gleaner Company Limited v. Assessment Committee*[1] the Privy Council observed as follows:—" Their Lordships have been referred to the practice of the inland revenue authorities in this country under similar provisions, which appear to sanction the practice of permitting debts that are bad to be deducted in the year the loss is sustained. Their Lordships are unable to attach any weight to this practice. It may be due either to a misunderstanding of the statute or it may be that if all the provisions of the various English Income Tax Acts were examined they might bear a different interpretation to those that are now before their Lordships, or again, the convenience of administration may have suggested this form of relief. Their Lordships are unable to appreciate how the establishment of this practice, although it may be of long standing, can afford them assistance in the present dispute. It may however afford some explanation of why the particular point has never been taken in English Courts, although in one or two cases to which attention has been called it may have been relevant for discussion". That case is also of importance, because section 10 of the Jamaica Ordinance expressly included any debts in the income from any trade except bad debts and doubtful debts.

Our law under Chapter III. is similiar in character to the Jamaican law in that debts are not to be deducted in estimating the profits or income of a trade excepting bad and doubtful debts, the only difference being that such debts are expressly mentioned in the Jamaican law and they arise by implication in our section 9 (1) (*d*). It will also be seen that our law is expressly worded so as to make it different from the Jamaican law as regards the year in which bad or doubtful debts are to be deducted, probably owing to the judgment of the Privy Council.

Chapter IV. of the Income Tax Ordinance relates to the ascertainment of what is called the statutory income of an assessee from each source which is to be the full amount of the profits or income which was derived by him or arose or accrued to his benefit from such source during the year preceding the year of assessment. Chapter V. lays down rules for the ascertainment of the assessable income, and it is got by taking the assessee's total statutory income and making certain specified deductions. Chapter VI. lays down rules for the ascertainment of the taxable income which is got by deducting from the assessable income certain specified deductions and Chapter VII. sets out the rates at which the tax is to be

[1] *(1922) 2 A. C. p. 169.*

charged on the taxable income. This seems to be the general scheme by which income tax is to be charged in Ceylon under the Income Tax Ordinance. It will be seen that the tax is to be levied on not merely income but also profits to be determined by the rules laid down in the Ordinance.

Mr. Perera in support of his argument laid great stress on the judgment of the Full Bench of Madras in the case of *Secretary to the Board of Revenue, Income Tax, Madras v. Arunachalam Chettiar*[1]. But if that case is carefully examined it will be found that it is against him. In the first place the Court was interpreting the words of the Income Tax Act of 1918, and the Chief Justice laid stress on the word "income" which appeared in section 3, the principal section which created the charge. He emphasized that it was the income which was taxed and that income meant actual receipts. The Chief Justice quoted with approval Lord Esher's judgment in *Gresham Life Assurance Society v. Styles*[2], in which he stated that the balance on which income tax was charged was "the difference between what was received in any three years and what it cost to obtain those receipts". The Chief Justice was of opinion that this decision supported his interpretation that "receipts" meant actual money received. Lord Esher made use of similar expressions in the case of *City of London Contract Corporation v. Styles*[3]. "How can you carry on a business after you have embarked your capital in the purchase of it? You must find new money in order to pay the expenses year by year; but then you do find money to pay the expenses year by year, and you get the receipts year by year, and the difference between the expenses necessary to earn the receipts of the year, and the receipts of the year are the profits of the business for the purpose of the income tax".

Commenting on this very passage Lord Sterndale M.R. in *Hall & Co. v. Commissioners of Inland Revenue*[4] said as follows:—"Of course the learned Master of the Rolls does not there mean by receipts money which is actually received; he means debts which will be received, and which therefore on their face value require an allowance for bad debts".

It will be seen by a reference to that case that there was no doubt at all that debts were to be included in reckoning the profits and loss, the only dispute being whether the profits were to be calculated for the year in which the two contracts were made or when the deliveries were made. Lord Sterndale said as follows:—"As I have said, the short and simple answer to the respondent's contention is that these profits were neither ascertained nor made at the time that these two contracts were concluded. Many contingencies might have happened to prevent the realization of profit which was anticipated when the contracts were made. Many complications might have occurred that might have produced a different result. I think that the respondents did right in the way that they carried these profits into their accounts; it is the ordinary commercial way of making up accounts, and in my opinion, it is the right way. It would be wrong to carry into the accounts, as profits of one year, the estimated profits which would accrue in subsequent years and which might perhaps never be made at all".

[1] *I. L. R. 44, Mad. 66.*
[2] *2 Tax Cases 638.*
[3] *2 Tax Cases 243.*
[4] *(1921) 3 K. B. 152.*

Atkin L.J. in the same case said as follows:—"The profits for excess profits duty are to be assessed on the same basis as profits for income tax purposes, and the word 'profits' for income tax purposes is to be understood in accordance with the words of Lord Halsbury in *Gresham Life Assurance Co. v. Styles* 'in its natural and proper sense—in a sense in which no commercial man would misunderstand'". Referring to a similar provision in the English law to ours, Lord Clyde in *Collins & Sons v. Commissioners of Inland Revenue*[1] stated as follows:—"It is a general principle, in the computation of the annual profits of trade or business under the Income Tax Acts, that those elements of profit or gain, and those only, enter into the computation which are earned or ascertained in the year to which the inquiry refers; and in like manner only those elements of loss or expense enter into the computation which are suffered or incurred during that year". That was a case dealing with excess profits duty but the law applicable was the same as the law applicable to income tax and the English rules in schedule D to the Income Tax Act, 1918, are more or less similar to our provisions, at any rate, so far as the fact that tax was levied on profits arising or accruing from a trade is concerned and the fact that deduction was to be made with respect to bad or doubtful debts.

The Full Court decision of the Madras High Court may be distinguished on the two grounds that the Indian Act of 1918 in section 3 referred to income; although in section 9 the word profits is used and the sentence is as follows: "the tax shall be payable by an assessee under the head 'income derived from business' in respect of the profits of any business carried on by him". The other ground is that there was no provision in the Indian Act for bad or doubtful debts. It was owing to this decision that the law was recast in India. The charging sections have been drafted to make it clear that the tax is leviable on income, profits, and gain; and by section 10 (3) the word "paid" means actually paid or incurred according to the method of accounting adopted. By section 13 although the choice of the method of accounting is left to the assessee a discretion is vested in the income tax officer to adopt any other method of accounting if by the system adopted the income, profits, or gain cannot be properly deduced.

So that it will be seen that the Madras case in no way supports the respondent's contention. On the other hand the English authorities on provisions of law similar to ours are decidedly in favour of the appellant. In the case of *In re The Spanish Prospecting Company Limited*[2] Fletcher-Moulton L.J., in a judgment which has been frequently quoted, explained what profits meant in a business. The following is an extract:—

"To render the ascertainment of the profits of a business of practical use it is evident that the assets, of whatever nature they may be, must be represented by their money value. But as a rule these assets exist in the shape of things or rights and not in the shape of money. The debts owed to the company may be good, bad, or doubtful. The figure inserted to represent stock-in-trade must be arrived at by a valuation of the actual articles. Property, of whatever nature it be, acquired in the course of

[1] *12 Tax Cases 780.* [2] *(1911) 1 Ch. 92.*

the business has a value varying with the condition of the market. It will be seen, therefore, that in almost every item of the account a question of valuation must come in. In the case of a company like that with which we have to deal in the present case this process of valuation is often exceedingly difficult, because the property to be valued may be such that there are no market quotations and no contemporaneous sales or purchases to afford a guide to its value. It is not to be wondered at, therefore, that in many cases companies that are managed in a conservative manner avoid the difficulty thus presented and content themselves by referring to assets of a speculative type without attempting to affix any specific value to them. But this does not in any way prevent the necessity of regarding them as forming a part of the assets of the company which must be included in the calculation by which *de facto* profits are arrived at. Profits may exist in kind as well as in cash. For instance, if a business is, so far as assets and liabilities are concerned, in the same position that it was in the year before with the exception that it has contrived during the year to acquire some property, say mining rights, which it had not previously possessed, it follows that those mining rights represent the profits of the year, and this whether or not they are specifically valued in the annual accounts."

It is true that he said that the actual profit and loss accounts of the company will not bind the Crown in arriving at the income tax to be paid. But he was referring principally to the habit of writing off liberally for depreciation.

Lord Justice Fletcher-Moulton's judgment was quoted with approval in *Kane v. Commissioners*[1]. In *Dailunnie-Talisker Distilleries Ltd. v. The Commissioners of Inland Revenue*[2], Lord Clyde said: "It is elementary that a profit and loss account is not an account of receipts and expenditure in cash only; its purpose is to show how the business stands, for better or worse, on the operations of the year". To adopt any other interpretation would be to nullify the intention of the legislature when it included section 9 (1) (*d*) in Chapter III. One of the practical difficulties is indicated in the dissenting judgment of Sadisiva Ayyer J. in the Madras case. I think it was to prevent an evasion of the law in the manner indicated by this Judge that our law was drafted.

As remarked by the Solicitor-General a money-lender could so adjust his accounts as to escape liability to be taxed. If only actual receipts were to be taxed, he could increase his capital year by year by borrowing money and the interest payable by him for such loans would automatically be deducted from his assessable income under section 13 (1) (*a*) so long as he complies with section 13 (7); for in my opinion section 13 (1) (*a*) (iv.) only applies when the non-payment or non-liability to pay is absolute.

One other point was pressed on us in appeal and as it was argued at length, I will briefly indicate it. The assessee was carrying on the business of a rice merchant in addition to his main business of money-lending. The Solicitor-General argues that the assessing officer has a

[1] *12 Tax Cases 338.* [2] *15 Tax Cases 620.*

right when taxing the assessee under section 6 (1) (*a*) to consider his income from the interest on loans under head 6 (1) (*e*) apart and then to bring it under 6 (1) (*a*) as part of the profits of both aspects of his business as money-lender and rice merchant. If he is right in his contention—as he appears to be from the opening words of section 9 (1)—then by section 9 (3) the interest due is to be reckoned whether it is paid or not without any deductions for outgoings or expenses. And there is provision in the sub-section for the deferring of the payment of tax and for the reduction of the assessment by the value of irrecoverable interest. Mr. Perera argues on the contrary that the effect of section 47 is to make section 9 (3) inapplicable when the assessment is made under section 6 (1) (*a*). But the words of section 47 say that when any provision relates expressly to any particular source of profits or income mentioned in section 6 (1) that provision is not to apply to the determination of any profits or income which is assessable and has been assessed as falling within any other source mentioned in that sub-section. The Solicitor-General replies that when he applied section 9 (3) he did so only with reference to section 6 (1) (*e*) and that it was after such application the profits were determined under section 6 (1) (*a*) with reference to both aspects of the assessee's business.

The question is not free from doubt. In favour of Mr. Perera's argument is the fact that under section 9 (1) all outgoings and expenses are to be deducted, but under section 9 (3) no deductions are to be made for outgoings and expenses. There will be some practical difficulty in giving effect to these contradictory provisions where two or more branches of the business are carried on by one staff of employees, but that is not a matter which affects the interpretation of the law. The fact that section 9 starts with the words that the section is "subject to the provisions of sub-sections (2) and (3)" shows I think that the draftsman contemplated a business being carried on with different sources of profit enumerated under section 6 (1).

There are many companies, particularly insurance companies, which invest their savings and profits on investments. Can it be said that section 9 (3) only applies to an ordinary investor? If so, why did the draftsman say that section 9 (1) which seems to apply mostly to those engaged in a trade, business, profession, vocation, or employment, is to be subject to sub-sections (2) and (3)? I am inclined to agree with the Solicitor-General's view. It makes no difference if the assessee carried on solely the business of lending money, for in that case the Crown has the choice of assessing him either under head 6 (1) (*a*) or 6 (1) (*e*). (*2 Tax Cases 172; 6 Tax Cases 376; and 8 Tax Cases 15.*)

If I am right, this will be an additional reason for the opinion I have already expressed that the decision of the Board of Review was wrong. The appeal will be allowed with costs incurred in this Court, and the deposit of Rs. 50 will be paid to the revenue and will be reckoned as part of the costs the assessee is ordered to pay. The assessment will therefore stand at Rs. 79,830.

MAARTENSZ J.—I agree.

Appeal allowed.