Business Income, Investment Income, and Investment Gains under the Inland Revenue Act of 2017

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The questions "what is business income?", "what is investment income?" and "what is an investment gain? (capital gain)" are of great significance in many areas of tax law and have formed the root of numerous income tax assessment considerations. It is not surprising that they have generated a substantial amount of discourse. This article attempts to discuss these questions in so far as they are relevant to determine the tax liability of a person resident in Sri Lanka.

Introduction

The Inland Revenue Act of 2017 ("IRA 2017") provides a new method of categorising income for the purposes of assessing income tax liability. A person resident in Sri Lanka is now chargeable with income tax in respect of his income arising from four categories, namely, employment, business, investment and other sources for the year.[1] This is called the assessable income of a person. In arriving at the assessable income various deductions of expenses will be made in accordance with Sections 11 to Section 19 of the IRA 2017. The total of the assessable income from each of the above named sources calculated separately is the taxable income for that year of assessment.[2] There are further deductions permitted under Section 52 of the IRA 2017 in computing the taxable income of a person from his assessable income.

I. What is Business Income?

The starting point of consideration as to whether a particular item of income can be assessed as business income is to determine whether the activity giving rise to the income can be

[1] Inland Revenue Act 2017, s 4 (1) (a) reads; The assessable income of a person for a year of assessment from employment, business, investment or other source shall be equal to – (a) in the case of a resident person, the person's income from employment, business, investment or other source for that year, wherever the source arise.
[2] Inland Revenue Act 2017, s 3 (1) reads; the taxable income of a person for a year of assessment shall be equal to the total of the person's assessable income for the year from each employment, business, investment and other sources.

characterised as a business. The expression business income was interpreted in a narrow manner under the IRA 2006. The IRA 2017 however attributes a much wider scope to the expression. The term business under tax law has garnered a considerable amount of judicial discussion. This chapter endeavours to define the term business income by examining the legal provisions and case law applicable under the IRA 2017.

i. Definition of what is a business under the IRA 2017 and 2006

The terms trade and business were defined in Section 217 of the IRA 2006. The term business was defined to include an agricultural undertaking, the racing of horses, the letting or leasing of any premises, including any land by a company and forestry. The term trade on the other hand was defined to include every trade and manufacture and every adventure and concern in the nature of trade.[3] According to Section 3 (j) profits of a casual and non-recurring nature were not within the scope of taxation. However, the inclusion of the phrase "every adventure and concern in the nature of trade" within the scope of the term trade indicated that profits from an isolated transaction could also be considered to be the profits of a trade provided that they were in the nature of trading.

The IRA 2017 slightly deviates from the abovementioned definition of a business and attempts to interpret the term in a more straightforward manner.

The term business is defined under Section 195 of the IRA 2017. The scope of the term as per this definition extends to a trade, profession, vocation, or any isolated arrangement having the characteristics of a business transaction (regardless of the duration of the arrangement), and any past, present or prospective business. An employment is specifically excluded from the purview of a business.[4] Since it includes a prospective business, a person at the stage of conducting preparatory activities towards conducting a business would also come within its scope.

In the landmark Australian judgement of Ferguson v. FCT[5] an officer of the Australian Navy who anticipated retirement entered into an agreement for the lease of five cows and thereafter entered into a management agreement with a company for the management of the cows. While the Commissioner was of the view that the taxpayer was in the process of preparing a

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[3] Inland Revenue Act No. 10 of 2006, s 217.
[4] Inland Revenue Act 2017, s 195.
[5] *Ferguson v. FCT* [1979] 9 ATR 873 (Full Federal Court).

business, the Court held that the taxpayer was carrying on a business. Significance was placed on the nature of the activity. The Court also examined whether there was a motive to make profits. It was stated that it is not necessary to establish an immediate profit making motive in the year of assessment under consideration. A person may be carrying on a business notwithstanding insignificant profits or even losses. Lord Coleridge CJ in Incorporated Council of Law Reporting[6] has also stated that the definition of the word trade does not necessarily mean something by which a profit is made.

The size and scope of the taxpayer's operation is another factor that the Ferguson case considered. If a person is buying and selling shares on the stock market at a small scale he would generally be treated as an investor. If he scales his operations and undertakes more transactions on a day to day basis, he is more likely to be characterised as a person carrying on the business of share trading. Going by this kind of example, it can be said that the larger the scale of the operation the more likely it is that a business is being carried on, whereas, the smaller the scale of the operation the less likely that a business is carried on.[7]

In the case of FCT v. Walker[8] it was held that a person who owned one goat was carrying on the business of goat breeding and was not merely an investor despite the lack of significant stocks. The Court emphasised on whether the respondent's activities were for the purpose of making a profit, despite him having made losses. They also noted the regularity and repetition in his activities, the fact that he organised his activities in a business-like manner and maintained books of accounts. Even though he had employed an expert veterinarian to carry out the breeding, the fact that he paid the fee for the process, procured the goat, communicated with the expert and made the decision to sell the goat on the basis of the market conditions played a vital role in the courts decision that he was carrying on a business.

The overall decisions in Ferguson and Walker were based on the premise that the system and organisation displayed by the taxpayer revealed that he was conducting his activities on a commercial basis. The cases of Thomas v. FCT[9] and Hope v. Bathurst City[10] reiterate this principle that a person may carry on a business if he does so on a commercial basis.

[6] *Incorporated Council of Law Reporting* [1888] 3 TC 105 (QB).
[7] Michael Kobetsky et al., Income tax text, materials and essential cases (8th edn federation press 2012) 161.
[8] *FCT v. Walker* [1985] 16 ATR 331 (Supreme Court of Queensland).
[9] *Thomas v. FCT* [1972] 3 ATR 165 (High Court of Australia).
[10] *Hope v. Bathurst City* [1980] 12 ATR 231 (High Court of Australia).

A business can be distinguished from a hobby. In Evans v. FCT[11] the Commissioner submitted that the taxpayer who was a very successful punter over a five year period was carrying on a business of punting. His success was attributed to the use of a system, and it was stated that significance should be placed on the fact that the taxpayer owned racehorses. The taxpayer's arguments were twofold. First, that his betting was haphazard and he did not utilise a system. He merely punted for enjoyment and was not carrying on a punting business. Secondly, that the racehorses were jointly owned with his girlfriend, due to the pleasure and prestige attached to winning races with his own horses and he was not deriving a profit therefrom. It was held that the taxpayer was not carrying on a punting business. His activities lacked the essential elements of there being a system and organisation to give him an advantage. It was unlikely that he was carrying on a business given the high level of chance involved. The likelihood of a taxpayer consistently selecting winning horses, other things being equal, was extremely low.

ii. What is business income

Under the earlier law, Section 3 (a) stipulated that income tax was chargeable on the profits and/or income of any trade, business, profession or vocation carried on or exercised, regardless of the duration of the activity.[12] The phrase "carried on or exercised" in Section 3 (a) must be emphasised. It implies that in order for a particular activity to be categorised as a business under the IRA 2006, it had to be a systematic, continuing or habitual process.

The IRA 2017 has largely deviated from the abovementioned interpretation of a business and the income arising thereof. It is clearly identifiable that the new provision attempts to progressively widen the scope of what constitutes business income.

The term Business Income is defined in Section 6 (1) of the IRA 2017 and reads; "A person's income from a business for a year of assessment shall be the person's gains and profits from conducting the business for the year." At the first instance, in order to understand the widening of the scope of the term business, the phrase "conducting the business" must be examined. Under the new Act it is sufficient that the taxpayer is conducting a business, as opposed to carrying on a business. The carrying on of a business is a continuing process, whereas the conduct of a business indicates a much narrower requirement.

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[11] *Evans v. FCT* [1989] 20 ATR 922 (Federal Court).
[12] Inland Revenue Act No. 10 of 2006, s 3 (a).

Section 6 (2) of the IRA 2017 provides for the computation of the gains and profits from conducting a business. The section reads; "In calculating a person's gains and profits from conducting a business for a year of assessment the following amounts derived by the person during the year of assessment from the business shall be included." In this section, the expression "from the business" implies a widening of the scope of what can constitute a business activity from the preceding section. The usage of the phrase "from the business" is an indication that any profit or gain that comes from the business will fall under the purview of this section.

Furthermore, Section 6 (2) lays down a number of factors derived by a taxpayer that will be included in the computation of income tax. Section 6 (2) (a) includes the service fees received by a taxpayer. Section 6 (2) (c) and (g) while providing for factors that would be included in income tax calculations, also widens the scope of the term business. Section 6 (2) (c) of the IRA 2017 reads; "gains from the realisation of capital assets and liabilities of the business as calculated under Chapter IV." The phrase "of the business" herein implies that even if a particular asset merely belongs to the business and is not particularly utilised for the purposes of the trading activities of the business, it will still be considered as business income for the purposes of computing income tax. Section 6 (2) (g) states; "amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from investment." In this sub clause the words "effectively connected with the business" indicate that even if a particular profit or gain is an investment income, if it is found to be effectively connected with the business, it will be treated as business income for the purposes of assessment under the IRA 2017. Accordingly, the position taken up by the Inland Revenue Department that companies who earn interest which are not carrying on finance business should treat such interest as "interest" and not business income for the purpose of the IRA 2006 would no longer be valid.

The abovementioned provisions demonstrate that there is a greater chance that a particular source of income would fall under the purview of business income for the purposes of the IRA 2017.

iii. "Carrying on a business" versus "conducting a business"

The position under the IRA 2006 can be illustrated by a number of judicial pronouncements from both Sri Lankan and English Courts. The decisions discussed below indicate how the terms trade and business when used in conjunction with the phrase "carried on or exercised" presupposes the attachment of a larger meaning to the terms.

In the case of Commissioner of Income Tax v. O. S. De Zoysa[13] the assesse whose land was requisitioned during the war purchased the land and nine hangars erected thereon after the war and made a profit by re selling them. The question before the Supreme Court was whether this transaction amounted to a trade. It was held that the purchase and resale did not amount to a trade or a business for the purposes of the Income Tax Ordinance. Basnayake C.J. while stating that in order for there to be a trade there must be some amount of repetition in the act of buying and selling cited Rowlatt J. and a line of English judgments on the same issue.

Rowlatt J. in the case of Pickford v. Quirke[14] elaborated on this idea by stating that while one transaction of buying and selling does not make a man a trader, if the transaction is repeated and becomes systematic, then he becomes a trader. In the case of Smith v. Anderson[15] it was said that the meaning of the expressions trade and business in income tax is of wider import as the usage of these words in association with the expression "carried on or exercised" implies a repetition of acts. Moreover, the expression trade even when used by itself implies the concept of a repetition of acts. Therefore, when coupled with words such as "carried on or exercised" it is beyond doubt that there should be a repetition of acts to constitute a trade.

The House of Lords in Grainger and Son v. Gough[16] famously stated that both exercising a trade and carrying on a business carry the same meaning that the trade or business must be exercised in a habitual and systematic manner. The question of whether a particular activity constitutes the carrying on of a business is a mixed question of fact and law.

The new position under the IRA 2017 is better reflected in certain principles developed by the Australian Courts. The Australian Courts lay down five factors that may be utilised to assess whether a taxpayer is carrying on a business, namely,

(1) the existence of a profit motive;

(2) the periodicity, regularity and recurrence of a transaction;

[13] *Commissioner of Income Tax v. O. S. De Zoysa* [1956] 1 CTC 524 (Supreme Court of Sri Lanka).
[14] *Pickford v. Quirke* [1927] 13 TC 251 (Court of Appeal).
[15] *Smith v. Anderson* [1880] L.R. 15 Ch. D. 247.
[16] *Grainger and Son v. Gough* [1896] 3 TC 462 (HL).

(3) the size and scale of the activities;

(4) the organization and system underlying the activities; and

(5) the commercial nature of the activities.[17]

It is interesting that there is no requirement that all these criteria be present together at the same time. The weight attached to each will differ on a case to case basis.

In the context of Section 6(1) and Section 6(2) of the IRA 2017 and the use of the terms "from conducting the business", "from the business", "effectively connected with the business", and "of the business" it is evident that if a person is considered to be in business most sources of income which relates to such business is likely to be considered to be business income for such a person.

iv. Isolated arrangement having the characteristics of a business transaction

In certain situations taxpayers may engage in isolated transactions where there is no evidence to show that the taxpayer had done anything in that nature before or is likely to do it again.[18] The assessment of isolated arrangements have created quite the conundrum. Under the IRA 2006 the test applied to determine whether an isolated transaction would be considered a business transaction was to see whether the transaction is in the nature of trade. Under the IRA 2017 the isolated arrangement must have the characteristics of a business transaction.

(a) The English law approach

Basnayake C.J. in the case of Commissioner of Income Tax v. O. S. De Zoysa[19] held that an isolated transaction does not amount to the carrying on or exercising of a trade or business within the meaning of Section 6 (1) (a) of the Income Tax Ordinance. The common law reflected a more relaxed treatment of isolated transactions and the decision in De Zoysa has not been followed in subsequent decisions.

The English cases of Commissioners of Inland Revenue v. Livingston[20] and Pickford v. Quirke[21] state that an adventure or concern in the nature of trade or a venture in the nature of

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[17] Kobetsky (n 7) 124.
[18] *Leeming v. Jones* [1930] 15 TC 333 (HL).
[19] *Commissioner of Income Tax v. O. S. De Zoysa* [1956] 1 CTC 524 (Supreme Court of Sri Lanka).
[20] *Commissioners of Inland Revenue v. Livingston* [1926] 11 T. C. 53 (Court of Session).

trade depending on the character and circumstances of the venture may be interpreted to be a business. In order to determine whether a particular venture is in the nature of trade, the test applied is to see 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 is made.[22]

The position under Sri Lankan law which was reflected in the IRA 2006 is best described by the case of H. V. Ram Iswara v. Commissiner of Inland Revenue.[23] The Appellant in this case was living in Hulftsdorp with her husband and five daughters. Four of her daughters were attending St. Bridget's Convent and wanted to move to a place closer to the school. A two-and-a-half-acre block of land was available in Alexandra Place, which the owner was only willing to sell as a whole. The Appellant who did not have sufficient funds borrowed money and bought the property. She thereafter divided the land into blocks and sold nine blocks and retained two for herself. The Privy Council held that even though the Appellant was motivated by her desire to reside closer to St. Bridget's Convent, the dominant motive was to sell the blocks of land in order to make a profit while obtaining a block for herself below the market value. Therefore, it was held that she was trading. The Privy Council further elaborated that the financial resources available to the appellant were insufficient to merely hold the property as an investment. Even the deposit for the land was borrowed. The crucial element in her plan was that the greater part of the land would be sold.

(b) The Australian approach

The starting point of the Australian approach on the matter is the decision of the Full Court of the High Court of Australia in FCT v. Myer Emporium Ltd.[24] The first strand of the Myer case stipulates that the proceeds of an isolated transaction are assessable income if the transaction was entered into in the course of a business with the intention of making profits. The second strand of the Myer case provides that if an income stream is capitalised into a

[21] *Pickford v. Quirke* [1927] 13 TC 251 (Court of Appeal).
[22] *Commissioners of Inland Revenue v. Livingston* [1926] 11 T. C. 53 (Court of Session).
[23] *H. V. Ram Iswara v. Commissiner of Inland Revenue* [1962] Vol II SLTC 241 (Supreme Court of Sri Lanka).
[24] *FCT v. Myer Emporium Ltd* [1987] 18 ATR 693 (Full High Court of Australia).

lump sum payment, the lump sum continues to have an income character.[25] Importance was placed on the profit making motive of the transaction under consideration.

This principle was reconsidered in Westfield Ltd. v. FCT.[26] wherein the taxpayer who was in the business of constructing and managing shopping centres purchased a land and sold it to a company on the condition that the taxpayer would design a new shopping centre on the land. Profits made on the sale of the land were assessed as business income. However, the Court stated that the transaction was not a part of the taxpayer's ordinary business nor a necessary incident of its business, and since the taxpayer had no intention of reselling the land to make a profit at the time of purchase, the receipt was capital in nature.

The application of the Myer principle can cause difficulties in certain cases. Every profit made in the course of a business activity cannot be assessed as business income. To consider the Myer test in this manner is to apply it too widely and to eliminate the distinction between income and capital profit. Following these cases two criteria to assess transactions from isolated arrangements were put forth. First, an intention or purpose to make a profit or gain must be present. Secondly, the transaction must be entered into and the profit must be made in the course of carrying on a business or a commercial transaction. The intention of making a profit is no longer the dominant criteria upon which such transactions will be assessed.[27]

In the context of the decision of H. V. Ram Iswara v. Commissioner of Inland Revenue and the inclusion of an isolated arrangement in the definition of a business under the IRA 2017 it is evident that the income from an isolated transaction could constitute business income.

II. Investment income and investment gains

There has been considerable debate over the taxation of investment income and the treatment of investment gains. In certain situations, there have been issues as to whether the income would constitute business income or investment income (i.e. interest or dividends under the IRA 2006). Furthermore, in certain other situations the income arising from the realisation of an investment asset or a capital asset maintained as an investment can be treated as either investment gain (i.e. a capital gain) or business income depending on the circumstances of the

[25] Section 30 of the Inland Revenue Act of 2017 contains similar provisions with respect to compensation payments.
[26] *Westfield Ltd. v. FCT* [1991] 21 ATR 1398 (Full Federal Court of Australia).
[27] Kobetsky (n 7) 161.

case. This distinction was significant under the IRA 2006 since capital gains were exempt from income tax. This chapter attempts to understand investment income as opposed to what would constitute business income as per the provisions of the IRA 2017. The distinction continues to be of importance since investment gains which constitutes a part of investment income could in certain circumstances be liable to be taxed at a concessionary rate of 10%.

i. What is investment income?

Investment income is taxed under Section 7 of the IRA 2017. It states that a person's gains and profits from an investment for a particular year is the income from that investment.[28] The following amounts received or derived from the investment made during the year of assessment will be included when calculating the investment income; Section 7 (2); (a)"dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties; (b) gains from the realisation of investment assets as calculated under Chapter IV."

Additionally, the IRA 2017 stipulates that a person receiving a final withholding payment during a year will be liable to pay income tax.[29] Section 84 of the Act deals with the withholding from investment returns. A resident person is bound to withhold tax in a number of circumstances, namely, when he pays a dividend, interest, discount, charge, natural resource payment, rent, royalty, premium, retirement payment, payment of winnings from a lottery, reward, betting and gambling.[30] In the case of a partnership, the preceding partner shall withhold tax.[31] In all the above scenarios, it is important that the payment or allocation has its source in Sri Lanka.[32]

Even though business income and investment income constitute a part of the taxable income of a person, its distinction could still be of importance for many companies which have income tax holidays on their business income under the Board of Investment Law No. 4 of 1978 (as amended). The income tax holiday is referable to the "business of the enterprise". Since business income would now cover investment income derived by a business under the IRA 2017 it is likely that the scope of the income tax exemption may be wider now than what was prevalent under the IRA 2006. A similar argument may not be available for the income

[28] Inland Revenue Act 2017, s 7 (1).
[29] Inland Revenue Act 2017, s 2 (1) (b).
[30] Inland Revenue Act 2017, s 84 (1) (a) (i).
[31] Inland Revenue Act 2017, s 84 (1) (a) (ii).
[32] Inland Revenue Act 2017, s 84 (1) (b).

tax exemptions gazetted under the Strategic Development Projects Act No. 14 of 2008 since the income tax exemptions relate to the profits from "the project" as defined therein.

ii. What are investment gains?

In terms of Section 7 (2) of the IRA 2017 gains from the realisation of investment assets are considered as investment income. Chapter IV of the IRA 2017 provides for the treatment of investment assets and liabilities and the gains thereof. Investment gains are the gains made by a person upon the realisation of an asset or a liability. This is calculated by taking into account the amount by which the consideration received for the asset or liability exceeds the cost of that asset or liability at the time of realisation.[33] In the converse, at the time of realisation, the losses from the realisation of an asset will be the amount by which the cost of the asset or liability exceeds the consideration received for the asset or liability.[34] If any part of the gain made from the realisation of an investment asset is included in a person's employment income or business income, such amount to the extent that it is included in such other source of income shall be reduced from the investment gains.[35] Furthermore, when the asset or liability is used in the production of two or more sources of income, the consideration received or the cost of the asset upon realisation will be apportioned between each source as per the market value of the parts utilised in the production of each source.[36]

The terms cost of an asset and the consideration received for an asset referred to above have been defined separately in Sections 37 and 38 of the Act. The cost of an asset includes the expenditure incurred in acquiring the asset and other expenses connected to such acquisition such as the construction, manufacture or production of the asset.[37] In addition, expenditure incurred in altering, improving, maintaining or repairing the asset and other incidental expenses in relation to the acquisition and realisation of the asset will be included.[38] Incidental expenditure is defined in the Act to include advertising expenditure, transfer taxes, duties, other expenditure of transfer, expenses in relation to the establishing, preserving, and defending of the ownership of the asset. Moreover, payments made towards the services obtained from an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer in relation to the abovementioned incidental expenses will also be considered as

[33] Inland Revenue Act 2017, s 36 (1).
[34] Inland Revenue Act 2017, s 36 (2).
[35] Inland Revenue Act 2017, s 36 (3).
[36] Inland Revenue Act 2017, s 36 (4).
[37] Inland Revenue Act 2017, s 37 (1) (a).
[38] Inland Revenue Act 2017, s 37 (1) (b) and (c).

incidental expenditure.[39] Certain income amounts may also be included in the computation of cost. Amounts that directly fall under the category of income by virtue of Division II of Chapter II, exempt amounts or final withholding payments, where all of the above results from the acquisition of an asset or the incurring of expenditure in the manner given under Section 37 (1) (b) and (c).[40] Finally, Section 37 of the Act specifically excludes consumption expenditure, excluded expenditure and expenditure to the extent that it is already deducted when calculating a person's income or included in the cost of another asset from the purview of the cost of an asset.[41]

III. Distinguishing business income and investment income

Not all business receipts are treated as assessable income according to ordinary concepts. Depending on the nature of the transaction business receipts can be assessed in a number of different ways. The proceeds from the sale of goods or services are generally considered business income. Difficulties may arise when deciding whether the income from dividends, interest, or discounts are income from a business or income from investments in certain circumstances. Furthermore, if a business sells a machinery in order to purchase a new item of plant, the proceeds from this transaction can be treated as being of a capital nature. All these different types of receipts may cause difficulties in the computation of income tax.

Unlike the present IRA 2017 which divides income into four distinct categories, the earlier IRA 2006 did not define investment income separately. The components of investment income such as dividends, interest, discounts,[42] charges, annuities,[43] rents, royalties and premiums[44] were each treated as separate sources of income and considered profits or income for the purposes of income tax. There were also limitations placed on deductibility of expenses relating to some of such sources (eg; no deductions against interest income). This brought about many issues since tax payers were arguing that interest earned on a regular basis by companies with excess liquidity should be treated as business income whereas the Inland Revenue Department was contending that it constituted interest simpliciter. The IRA 2017 has expanded the deductibility of expenses from investment income and consequently the distinction between business income and investment income has lessened to some extent.

[39] Inland Revenue Act 2017, s 37 (4).
[40] Inland Revenue Act 2017, s 37 (2).
[41] Inland Revenue Act 2017, s 37 (3).
[42] Inland Revenue Act No. 10 of 2006, s 3 (e).
[43] Inland Revenue Act No. 10 of 2006, s 3 (f).
[44] Inland Revenue Act No. 10 of 2006, s 3 (g).

However, there is a limitation that investment losses can only be deducted from income from investments,[45] whereas business losses can be deducted from either business income or from investment income.[46]

While the IRA 2017 seems to attempt to rectify this by providing that investment income forms a separate source of income that is to be calculated separately, problems may still arise in distinguishing the various sources of income. This chapter will illustrate the principles developed to distinguish business income from investment income.

i. The relaxing of the strict English law doctrine in Nuclear Electric PLC

Whether the investment income of a business entity can be treated as business income requires an analysis of the business in question. It is important to establish that there is a strong link between the investment and the business entity. The common law stipulates that the investment must be an "integral part of the business". This is determined by examining the nature of the business and establishing that the making or holding of investments is an integral part of the business and that there is a strong link between the investment and the liabilities to be met.[47] This principle is embodied in a plethora of judgments of the House of Lords and an analysis of our very own IRA 2006.

In the landmark House of Lords decision of Nuclear Electric Plc v. Bradley[48] a taxpayer who was in the trade of generating electricity set aside a considerable sum of money as an investment to meet the back end cost of decommissioning a nuclear reactor. The Court opined that this transaction was not within the ambit of the term "trading income".[49] Such investment was neither an integral part of the trade of generating electricity, nor could it be said that the funds set aside would be used for the purpose of decommissioning reactors or

[45] Inland Revenue Act 2017, s 19(4)(b).
[46] Inland Revenue Act 2017, S 19(1)(a); Inland Revenue Act 2017, 19(4)(a).
[47] S Balaratnam, *Income tax in Sri Lanka* (3rd edn, Tax Publications Ltd 2001) 225.
[48] *Nuclear Electric Plc v. Bradley* [1995] STC 1125 (HL).
[49] Corporation Taxes Act 1988, s 393 (8); For the purposes of this section "trading income" means, in relation to any trade, the income which falls or would fall to be included in respect of the trade in the total profits of the company; but where—
(a)in an accounting period a company incurs a loss in a trade in respect of which it is within the charge to corporation tax under Case I or V of Schedule D, and
(b)in any later accounting period to which the loss or any part of it is carried forward under subsection (1) above relief in respect thereof cannot be given, or cannot wholly be given, because the amount of the trading income of the trade is insufficient,
any interest or dividends on investments which would fall to be taken into account as trading receipts in computing that trading income but for the fact that they have been subjected to tax under other provisions shall be treated for the purposes of subsection (1) above as if they were trading income of the trade.

disposing spent fuel over a period as long as the projected 80 years. Investment income cannot be converted into trading income by simply creating a segregated fund. Lord Justice Millet stated that at the first instance the very long term nature of the liabilities makes it possible to carry on business for a long period without maintaining any fund. The existence of the fund is not to meet the liabilities in question but due to the fact that no better use could be found for the money. It was also noted that the liabilities in question are liabilities to third parties and not liabilities to the customers. Therefore, the test to be applied was to see whether the investments formed an integral part of the business of the company.

While the principle illustrated above was applied in cases under the IRA 2006, we see a relaxation of the strict requirement of the investment being an integral part of the business under the IRA 2017. Under the IRA 2017 when capital assets are maintained as investments, they will be considered as investment assets. The gains from the realisation of investment assets will be adjudged on the basis that they are either effectively connected with the business or that they are not effectively connected with the business. If the gains from the realisation of an investment asset is effectively connected to the business, it will be deemed to be business income.

ii. Transactions within the ordinary scope of the taxpayer's business

The Australian Courts evaluate whether a transaction is within the ordinary scope of the taxpayer's business in order to determine whether the receipt from the transaction is business income or investment income.

Lord Justice Clerk in Californian Copper Syndicate v. Harris[50] stated that it is a well settled principle in dealing with the assessment of income tax that where the owner of an ordinary investment chooses to realise it and obtains a higher price for it than what it originally cost such enhanced price is not profit. In the meantime, the enhanced values obtained from the realisation or conversion of securities may be so assessable when the transaction is not merely a realisation or change of investment but is a transaction in the carrying on of a business. It was further stated that there is a fine line separating these two classes of cases and therefore each must be considered on the basis of its facts. The question to ponder is whether the gain is made by way of a mere enhancement of value by realising a security, or is the gain

[50] *Californian Copper Syndicate v. Harris* [1904] 5 TC 159 (High Court of Australia).

made in the carrying out of a scheme for profit making or the operation of a business in other words.

In the case of London Australia Investment Co Ltd. v. FCT[51] and a number of other cases the difficulties faced when applying the principle set out in the Californian Copper Syndicate case were discussed. Barwick CJ stated that the Californian Copper Syndicate provides no criteria upon which questions of this nature can be considered. Everything that is produced by a business will be income in general. But it is the nature of the business, defined precisely, and the relationship of the source of the profit or gain to the business that will determine whether or not it is business income.

iii. Acquisition and sale of assets

Chapter IV of the IRA 2017 deals with assets and liabilities and the calculation of gains and losses therefrom. Section 6 (2) (c) of the IRA 2017 states that in calculating a person's gains and profits from conducting a business the gains from the realisation of capital assets would be included.[52] In terms of the definition of capital asset under Section 195 of the IRA 2017, land and buildings, shares, or a partnership interest, and securities and other financial assets are included, but it specifically excludes a depreciable asset (eg; building). The said Section also includes a definition of an "investment asset" which includes a capital asset held as part of an "investment". The term investment in turn has also been defined and it specifically excludes a business[53].

The difficulty which arises is whether the receipts from the realisation of an asset is business income or investment income. Lord Wilberforce in the case of Simmons v. IRC[54] stated the principles applicable to cases of this nature. At the first instance trading requires an intention to trade. Therefore, one must ask whether this intention existed at the time of acquisition of the asset. If the asset was acquired as a permanent investment and was sold in order to acquire another investment, this transaction does not involve a trade, whether the first investment was sold at a profit or a loss. It was also stated that intentions may be changed. An investment may be put into the trading stock and vice versa. What is not possible is for an asset to be both trading stock and a permanent investment at the same time. When the initial

[51] *London Australia Investment Co Ltd. v. FCT* [1977] 7 ATR 757 (High Court of Australia).
[52] Inland Revenue Act of 2017, s 6(2)(c).
[53] Inland Revenue Act of 2017, s 195.
[54] *Simmons v. IRC* [1980] 1 WLR 1196.

intention is to acquire an asset as an investment, and it was later sold, this decision to liquidate is a mere ending of the investment plans, and not evidence of a trading intention.

In the case of Eames v. Stepnell Properties Ltd.[55] it was said that if an asset is acquired as an investment initially, the fact that it is later sold does not take it out of a category of investment or render its disposal in the course of trade, unless there was a change in the intention of the owner. Moreover, whether an item is held as capital or as stock in trade is not determined by the way in which it is treated in the owner's books of accounts.[56]

The distinction is of importance since in terms of Item 1 (2)(a) and Item 4 (4)(a) of the First Schedule of the IRA 2017 the gains from the realisation of investment assets of individuals and companies respectively are taxed at the concessionary rate of 10%. Accordingly, the IRA 2017 acknowledges the fact that a company could continue to have investment gains from investment assets which it holds.

Conclusion

The concepts of business income, investment income and investment gains are fundamental in establishing liability to income tax in Sri Lanka. In summary:

1. Both under the IRA 2006 and IRA 2017 it would be necessary to first determine that there is a "business" from which the income is being derived.
2. Under the IRA 2017 if a person is considered to be in business, most income derived by the business would be considered as business income.
3. It would no longer be necessary to establish that income such as interest is an integral part of the business in order for it to be considered as business income.
4. Isolated transactions would continue to be taxable as business income, and such likelihood is higher under the IRA 2017.
5. Even a company which has business income could have gains from the realisation of investment assets which will be taxed as 10%. However, the likelihood of such gains being considered as business income is higher under the IRA 2017.

[55] *Eames v. Stepnell Properties Ltd.* [1967] 1 WLR 593.

[56] *CIR v. Scottish Automobile and General Insurance Co. Ltd*. [1932] SC 87; *Rellim Ltd v. Vise* 32 TC 254 (High Court of Calcutta).

6. Gains from the realisation of investment assets by individuals would be taxed at 10% provided that such individuals cannot be considered to be in the business of dealing in such assets.