

**IN THE COURT OF APPEAL OF THE DEMOCRATIC SOCIALIST
REPUBLIC OF SRI LANKA**

*In the matter of an Application of a case
stated under Section 11A of the Tax
Appeals Commission Act No. 23 of 2011
as amended by Act No. 20 of 2013.*

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

Appellant

Court of Appeal Application
No: **CA/TAX/10/2021**

Vs.

Case Stated:
TAC/TT/051/2017

Fonterra Brands Lanka (Pvt) Ltd,
No. 100, Delgoda Road,
Biyagama.

Respondent

BEFORE

: D. N. Samarakoon J
Neil Iddawala J

COUNSEL : Chaya Sri Nammuni DSG for the Appellant.
 Manoj Bandara with Praveena Muhandiram for the Respondent, instructed by Sudath Perera Associates

Argued on : 27.07.2023

Written Submissions filed on : 10.10.2023

Decided on : 02.11.2023

Iddawala – J

This is an application made by the Commissioner General of Inland Revenue (*hereinafter referred to as the Appellant*) under the Tax Appeals Commission Act No. 23 of 2011 as amended challenging a determination made by the Tax Appeals Commission (*hereinafter referred to as the TAC*) regarding the taxation of Fonterra Brands Lanka (Pvt) Ltd. (*hereinafter referred to as the Respondent*).

The instant appeal is made against the assessment made for the taxable period 2011/2012 which was heard by the TAC on 21.01.2021. The Respondent is a limited liability company incorporated in Sri Lanka engaged in importing, manufacturing and distribution of dairy products. The largest shareholder of the Respondent is Fonterra Brands (Singapore) Pvt. Ltd. which is in turn a wholly owned subsidiary of Fonterra Co-operative Group Ltd. of New Zealand. The Respondent entered into a licensing agreement with the 'New Zealand Milk Brands Ltd.' for ten years with effect from 01.06.2006 as licensor granting a non-exclusive right to the Respondent to use the "technical Know-How and Communication Package" in connection with the manufacture, packaging,

marketing, distribution and sale of products in Sri Lanka. The Agreement also provided for the payment of royalty of 4% from the net sales amount. The Respondent company has claimed and deducted Rs. 585,880,132/= as royalty payment from the statutory income for the assessment year 2011/2012, which had been paid to an associate company in the group of companies called New Zealand Milk Brands Ltd., which is closely connected to the Appellant. The Assessor disallowed the royalty payments and issued an assessment against which the Respondent appealed to the Appellant who confirmed the assessment. Thereafter the Respondent appealed to the TAC which annulled the assessment. At the request of the Appellant the TAC has forwarded this Case Stated containing the following questions of law in accordance with Section 11A of the TAC Act;

1. *Whether the TAC erred in law when determining the payment of royalty amounting to Rs. 585, 880,132/- was not excessive?*
2. *Whether the TAC erred in law when determining that the royalty payment to the Fonterra Co-operative Group Ltd. Was correct though the agreement was to pay the given amount to New Zealand Milk Brand Ltd who was actually entered into agreement with the Fonterra Brands Lanka (Pvt) Ltd.?*

This Court is of the opinion that both of these questions are not questions of law but of fact. The first question is to determine whether the royalty payment was 'excessive' and the second question involves determining who the real receiver of the royalty payment was. However, the submissions of the parties have provided certain legal provisions in support of their stances. This Court would consider such legal provisions and the law referred to by the TAC in their determination, interpreting them to provide more clarity to the matter. This Court is mandated to determine on questions of law under the TAC Act, therefore the judiciary being the upholder of law, is inherently obliged to draw

attention to improper or inadequate adherences to legal provisions even if it is seemingly related to a question of fact.

Firstly, this Court intends to interpret legal provisions that have allowed royalty to be a deduction from the statutory income. Both The TAC in their determination and the Respondent in their submissions have stated that royalty deductions are allowed under section 32 of the IR Act. However, in the instant matter this Court has reservations on Royalty being a permitted deduction under Section 32. It is pertinent that the TAC refers to the exact provision when indicating such concessions/deductions without referring to the overarching section. In the written submissions of the Respondent, it is under S. 32(5) the deduction is justified by the Respondent. The provision is as follows;

S. 32 -

(5) There shall be deducted from the total statutory income of a person for any year of assessment—

(a) sums paid by such person for any year of assessment by way of:

(i) any ground rent or royalty payable for any period prior to April 1, 2014 and which is paid after April 1, 2014; or

(ii) annuity or interest, which he is not entitled to deduct under section 25.

The portion on royalty payable for any period prior to April 1 2014 and paid after April 1 2014 being deductible from total statutory income was incorporated to the Act from the Inland Revenue (Amendment) Act, No.08 of 2014 [Certified on 24th April 2014]. It is evident from the audited accounts of this case that the royalty was paid from 2011-2012, therefore deductions under Section 32 (5) do not apply. Thus, this Court is of the opinion that the

TAC has not referred to proper law when justifying the deductions on statutory income by the Respondent.

Furthermore, the Appellant has submitted that under Section 82 of the IR Act that the Respondent is liable to pay income tax without deducting the Royalty. The section is as follows;

82. Liability of certain non-resident persons.

(1) For the purposes of this section—

(a) a person is closely connected with another person, where the Commissioner-General is satisfied that such persons are substantially identical or that the ultimate controlling interest of each is owned or deemed under this section to be owned by the same person or persons;

(b) the controlling interest of a company shall be deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees, and shares in one company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company.

(2) Where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profits or less than the ordinary profits which might be expected to arise from such business, the business done by the non-resident person in pursuance of his connection with the resident person shall be deemed to be carried on in Sri Lanka, and such non-resident person shall be assessable and chargeable with income tax in respect of his profits from such business in the name of the resident person, as if the resident person were his agent, and all the provisions of this Act shall apply accordingly.

Under the sub-section (2) the requirement of producing either no profits or less than the ordinary profits which might be expected to arise from such business

to the resident company is unnegotiable. At this instance, the burden is on the Appellant to showcase that the respondent company is not profiting or produces less than ordinary profits. From the perusal of the TAC determination and other assessment records it is evident to this Court that Rs. 1,175,570,925/- is indicated to be the profit for the relevant years. This Court notices that the Appellant claims a different amount, larger (Rs 1,357,403,648/-) than the amount mentioned in the case stated to be the royalty payment. There is no reference to this amount in the TAC determination as well. The Appellant moves on to base their submissions under Section 82 relying on this subsequent amount claiming it is 98% of the Respondent company's profit. This Court is confused why this subsequent amount has been brought in later at this stage, as it is not the mandate of this Court to determine on questions of fact. However, in the interest of clarity and as this fact is essential to interpret above-mentioned legal provisions, considering submissions of the Respondent and company audited accounts, this Court agrees to the position of the Respondent that the amount of Rs 1,357,403,648/- the Appellant is relying on as the royalty paid, is the royalty provision and not the actual royalty paid, which is Rs. 585, 880,132/-. Therefore, this Court deems the submissions of the Appellant under this provision to be mistaken, groundless and unsubstantiated.

The Appellant refers to Section 103 of the IR Act together with S. 82 as well;

S. 103 - Where an Assessor or Assistant Commissioner is of the opinion that any transaction which reduces or would have the effect of reducing the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the parties to the transaction or disposition shall be assessable accordingly

The submission of the Appellant is that as under S. 82(2) 98% of the profit was transferred to the New Zealand Milk Brands Ltd, it amounts to a fictitious

transaction which reduces the amount of tax. However, having determined the Appellant has successfully established requisites under S. 82, the applicability S. 103 fades as well.

For the reasons set out above, this Court holds that the TAC has not referred to proper law in determining whether royalty is deductible from statutory income of the Respondent company for the year 2011/2012. This Court answers the questions of law in the case stated for the opinion of this Court as follows:

1. Yes, as the legal provision allowed the deduction is ambiguous.
2. Does not arise as it is not a question of law

In light of the answers given to the above two questions of law formulated by the TAC, this Court remits case to the Commission with the opinion of the Court, acting under Section 11A (6) of the TAC Act.

(The Registrar is directed to send a copy of this judgment to the Secretary of the TAC.)

JUDGE OF THE COURT OF APPEAL

D. N. Samarakoon J.

I agree.

JUDGE OF THE COURT OF APPEAL