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

In the matter of a case stated Under Section 11A of the Tax Appeal 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 Chiththampalam A. Gardiner Mw, Colombo 02.

Court of Appeal No.
CA/TAX/47/2019
Tax Appeal Commission Appeal No.
TAC/IT/020/2016

APPELLANT

Vs.

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

RESPONDENT

Before: S.U.B. Karalliyadde, J
Mayadunne Corea, J

Counsel: Nayomi Kahawita S.S.C. for the Appellant.
Manoj Bandara with Praveena Muhandiram for the Respondent.

Argued on: 02.10.2023

Written Submissions:	For the Appellant on 14/02/2024, 06/08/2024 For the Respondent on 04/12/2023, 27/08/2024
Decided on:	30/10/2024

Mayadunne Corea J

The Respondent is a company that imports, manufactures, and distributes dairy products. As per the submissions made, the main shareholder is Fonterra Brands Singapore (Pvt) Limited. According to the written submissions of the Respondent the ultimate parent entity of the entire group is the Fonterra Co-Operative Group of New Zealand (herein referred to as "FCG"). The Respondent had entered into a licence agreement with another company, New Zealand Milk Brands Limited (herein referred to as "NZMB"). However, it is the contention of the Appellant that NZMB has instructed Fonterra Brands Lanka (Pvt) Ltd (herein referred to as "FBL"), the Respondent to remit royalties to FCG. This is also borne out by the letter of intimation found on page 51 of the brief. This contention was never challenged by the Respondent but in fact was admitted by the Respondent.

As per the licencing agreement which has come into effect from 01.06.2006, the Licensor has allowed the Licensee to use the "Technical Know How" of the Licensor for the manufacturing of products and also the "Communication Package" for the marketing of the dairy products which included the milk powder. It is pertinent to note that as per the licensing agreement Clause 4.1, a royalty payment should be made for the Respondent to use the said Technical Know How and the Communication Package. The said agreement had been in place from the year 2006.

In the assessment of the Respondent for the year 2010-2011, the Respondent has claimed a royalty payment of Rs. 1,037,513,135 as per the license agreement the Respondent had entered. The Assessor had not accepted the tax return and made an assessment for 2010-2011 disallowing the royalty payment. Being dissatisfied, the Respondent had appealed to the Commissioner General of Inland Revenue (herein referred to as the "CGIR") who in his determination dated 15.12.2015 confirmed the assessment of the Assessor. Being aggrieved, the Respondent appealed to the Tax Appeal Commission (herein referred to as the "TAC") which allowed the respondents appeal. Being dissatisfied with the said appeal the Commissioner General of Inland

Revenue has sought the opinion of this Court by way of a case stated on the following questions of law:

I. The payments Rs. 1,037,513,135/- as royalty deducted from the profit of the company.

II. The payment has been made to the associate company which shows the arrangement for the purpose of deducting tax.

However, subsequently, the Appellant sought to amend the questions of law to read as follows:

I. Did the Tax Appeal Commission err in law in holding that the Appellant had failed to adduce any acceptable reasons to deny the royalty payments under Section 32 of the Inland Revenue Act as amended?

II. Did the Tax Appeal Commission err in law when it concluded that the sums relevant to this appeal did not fall within the ambit of Section 82(2) of the Inland Revenue Act as amended?

The Respondent objected to the amendments. However, subsequently the said objections were withdrawn, and on the agreement of both parties, the Court was invited to answer the amended questions of law. At the argument stage, both Counsel conceded that the fact in issue is whether the Respondent is entitled to the deduction pertaining to the royalty payment or whether the Appellant disallowing the same by invoking Section 82(2) of the Inland Revenue Act is lawful.

Did the Tax Appeal Commission err in Law in holding that the Appellant had failed to adduce any acceptable reasons to deny the royalty payments under Section 32 of the Inland Revenue Act as amended?

As per the license agreement entered into between the Respondent and NZMB, the Respondent has to pay 4% royalty rate payable in respect of the net sales price of the product. The said 4% consists of 2.5% attributable to the use of the Communication Package and 1.5% attributable to the use of the Technical Know How.

The Respondent submitted that the Technical Know How meant the confidential information relative to specifications formula, techniques, secret knowhow, quality

control standards and methods of assessments, technical details provided from time to time by or on behalf of the Licensor to the Licensee for the use in the manufacture, packaging, marketing, distributions, sales of products. The Communication Package as per the licence agreement means the creative strategies, advertising, packaging, point of sales material, copy and graphics provided by the Licensor from time to time for the Licensee to use for marketing the product.

It is apparent that as per the said agreement 4% of the net sales price of the product should be paid as royalty. As per the statement of accounts submitted (page 127 of the brief) the sum of Rs. 1,037,513,135 has been paid as royalties. As per the same statement, the Respondent had paid a sum of Rs. 556,512,379 as income tax. The Respondent had sought to deduct the royalties paid from the assessable income of the Respondent. This has been done in terms of Section 32 (5) of the Inland Revenue Act, No.10 of 2006 as amended (hereinafter referred to as "IRA"), where it is stated as follows:

> *"32…*
>
> *(5) there shall be deducted from the total statutory income of a person for any year of assessment-*
>
> > *(a) any sum 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 s.25."*
>
> *For the purpose of this paragraph interest does not include the excess referred to in paragraph (x) or paragraph (y) of sub-Section (1) of Section 26*

We have considered the submissions of the Appellant who in turn argued that under Section 26(1)(m) no deduction is permitted for any royalty payment. The said Section states as follows;

> *"26 (1) For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of –*

... m) any ground rent or royalty payable for any period prior to April 1, 2014 and paid after April 1, 2014 which is deductible under paragraph (a) of sub-Section (5) of Section 32 or annuity paid by such person;"

As per the CGIR determination, the only ground the CGIR has given for disallowing the royalty is under Section 26(1)(m). This Court will consider the applicability of the said Section. The Section contemplates the ascertainment of profit or income. However, Section 32 stipulates the deductions permitted from the total statutory income in arriving at the assessable income. Under Section 32(5) *royalty paid for the period stipulated in the said section is deductible.* The taxable period in question is 2010/2011. Hence, in our view, there is no material to establish the applicability of this Section. It is pertinent to note that none of the Counsel made submission on the applicability of Section 32(5), other than the Respondent merely submitting that the deduction should be allowed under the said Section. However, whether the royalties paid, fell within the time period stipulated in the Section or not was not addressed by any of the Counsel. In the absence of such material and considering the taxable period the Court has come to the above conclusion. This will be further elaborated later in this judgment.

As the Respondent has failed to demonstrate that the payment of royalty fell within the time period stipulated in the Section, this Court has come to the conclusion that in this instance royalty is not a permitted deduction stipulated under Section 32(5). It is also pertinent to note that under Section 39 the said royalty payments become chargeable under the IRA at the appropriate rate specified in the Fifth Schedule.

However, it is also observed that pursuant to the provisions contained in Section 25, the taxpayer is entitled to deduct ¼ of the payment for obtaining the license stipulated as in the said Section in ascertaining the profit and income subjected to the proviso pertaining to which no evidence was submitted.

It was the contention of the Respondent that they were entitled to the deduction under Section 32(5) of the IRA, No. 10 of 2006. The said Section does not permit a blank deduction. It is clear that if the taxpayer is to claim the benefit under Section 32(5) then it should qualify under the provisions laid therein. As per the Section, for the taxpayer to qualify the payment should be for a period prior to April 1st 2014, which the taxpayer in this instance qualifies for. However, the next qualification is that it should be paid after April 1st 2014. The assessment in question is for the period of 2010/2011, this is

further demonstrated in the audited accounts which demonstrates that the payment was made within the assessment period of 2010/2011. Hence, in our view, *prima facie* the taxpayer does not qualify to obtain the benefit. As stated above, the Respondent has failed to demonstrate how his payment is caught up within the said Section. Further, this Court is of the view that when the taxpayer contends that they qualify under the Section then it is up to them to establish the same.

The Assessor has rejected the assessment pursuant to Section 26(1) of the IRA (page 141 of the brief). The Assessor has rejected the assessment on the basis of Section 82 of the IRA whereby the Assessor had attempted to invoke Section 82 of the IRA and held, that due to the close relationship between the parties, the Assessor had disallowed the royalty payment deductions pursuant to Section 25 or 32. As stated above, Section 25(1)(b)(i) permits the Respondent to deduct one fourth of the payment subject to the proviso therein.

> *"25. ...*
>
> *(b) (i) a sum equal to one fourth of any payment made by such person as consideration for obtaining a license in his favour of any manufacturing process used by such person in any trade or business carried on by such person;"*

The Respondent is also entitled to a deduction under Section 32(5)(a) provided the royalty payable fell within the stipulated time period. However, the Assessor has denied the deduction by invoking Section 82. The Assessor has gone on the basis of a graph found on page 140 of the brief, in which he demonstrates the license fees paid for a period of 11 years, the license fees paid and the percentage of the same to the statutory income. On the said basis he had invoked Section 82 and denied the deductions under Section 25 or 32. The determination of CGIR found on page 09 of the brief too has been determined on the same basis. Therefore, in our view, the CGIR has not considered the applicability of Section 25 or 32 separately.

In the TAC determination, the TAC has come to the conclusion that the Respondent before them, who is the Appellant before this Court, the CGIR, has not seriously considered Section 32(5) of the IRA. The TAC has further determined that as per Section 32 of the IRA, royalty is a permitted deduction. In our view, the TAC has failed to consider that Section 32(5) does not permit an absolute deduction but the royalty payment due period and the payment period has to be within the time period stipulated in the Section. The Assessor has come to the conclusion that the deduction is not

permitted under Section 25 or 32. However, he has come to the said conclusion only by invoking Section 82.

However, in answering the question the way it is raised before this Court, we find the Appellant has not sufficiently considered the application of Section 32(5) but has given reasons as to why deductions under Section 32 cannot be allowed, based on invoking the provisions of Section 82. Thus, the TAC has come to its conclusion that the reasons given are not acceptable.

Did the Tax Appeal Commission err in law when it concluded that the sums relevant to this appeal did not fall within the ambit of Section 82(2) of the Inland Revenue Act as amended?

As per Section 82, the Appellant argued that as the Respondent FBL and NZMB are closely connected, the resident party is liable to pay taxes. Going through shareholdings it is clear that the parties concerned are in fact closely connected. In view of this connection, the need for payment of royalties were questioned. It is the Appellant's contention that in view of this close connection in the guise of royalties what really happens is a transfer of profits from Sri Lanka to New Zealand. The royalty agreement is between NZMB and FBL (at page 138 of the brief). It was the contention of the Appellant that this payment of royalties, makes the profits earned by the Respondent less than the ordinary profits which would have arisen from the business.

In this instance, for Section 82 to operate, the Commissioner General must be satisfied that the conditions innumerate in Section 82(1)(a) and (b) are fulfilled. Thereafter Section 82(2) states as follows:

> *"82.*
>
> *(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."*

After careful consideration, we find that for Section 82(2) to operate the main ingredient is that a non-resident person should carry on a business with a resident person. This requirement is fulfilled. However, the second limb of the Section stipulates that the business should be so arranged that the resident person should be left with no profit or less than the ordinary profit which might be expected to arise from the said business.

As per the license agreement the royalty is paid on the basis of a percentage on the net sales price. As the agreement defines net sales price, it is quite clear that the net sales will depend on the market modalities of the country. Hence, if net sales go down the value of royalties paid will have a proportionately low value. This Court is also mindful of the provisions of Section 104 of the IRA pertaining to the arm's length pricing between international transactions. The violation of arm's length pricing would allow the Assessor or an Assistant Commissioner to make an assessment as per the provisions of the said Section. However, in this instance that situation has not arisen. As stated previously, for Section 82 to operate, the Appellant should have established that the resident person has either no profits or less than ordinary profits that are expected to arise from such ordinary business.

In this instance, the entity concerned earned a profit, but the question would be whether it is less than the ordinary profit.

The Appellant nor the Respondent have produced any material and have failed to demonstrate what an ordinary profit is, which would have triggered the invocation of Section 82(2). It is the contention of the Respondent that as per the statement of accounts the company has a net profit of Rs. 728,546,187 and has also paid income tax worth Rs. 556,512,379. Hence, it is the view of this Court that the resident person in this instance has declared a profit. Then, has the IRD established that the resident person in this instance has declared a profit less than the ordinary profits that are expected to arise from such ordinary business. This Court is unable to find any reasons given by the Appellant to establish that the Respondent has declared a profit less than the ordinary profit other than based on the amount paid as royalty, the statutory income in the audited accounts.

It is also apparent as per the determination of the CGIR it has come to the conclusion on the applicability of Section 82(2) purely on the basis of the connection between the two parties and on the payment of Rs.1,037,513,135 as a royalty payment. It is further stated the said sum is paid from the statutory income. It is also pertinent to note that

after the deduction of the royalty as per the audited accounts a net profit of Rs. 738,946,187 has been declared. The CGIR has based its assessment on these findings and come to the conclusion that the royalty paid is higher than the remaining profit of the business. Thus, reducing the payment of taxes.

This Court observes that if there are sufficient grounds to invoke Section 82(2) the Appellant has the right to act pursuant to the said Section. However, as per the Appellant's contention, even if the payment of royalty amounts to a transfer of profits from Sri Lanka to another country does that enable the Appellant to deny the deduction on royalty payment? The payment of royalty is based on a license contract the parties have entered into. As per the submissions, it is clear what the Assessor has done is to disallow the royalty payment by invoking Section 82(2) of the Inland Revenue Act.

It is the view of this Court that as stated above if the grounds to invoke Section 82(2) exist it is a separate process that has to be followed as prescribed in the Section and as per the law which in our view is available to the Appellant. However, the Appellant cannot invoke the said Section to disallow the royalty payments allowed under the statute. As per the determination of the TAC, it has given its mind to this aspect and has quite correctly come to its determination.

In answering the question before this Court, it is to be observed that the TAC has not come to the conclusion as to whether the sums relevant to this appeal fell within the ambit of Section 82(2). But what this Court observes is that the TAC has come to the conclusion that it arrived on the basis that the Assessor has not given acceptable reasons for denying the royalty payment.

Hence, this Court answers the second question in the negative.

For the reasons stated above, this Court sees no reason to interfere with the determination of the TAC. Therefore, this Court answers the questions as follows:

I. Did the Tax Appeal Commission err in law in holding that the Appellant had failed to adduce any acceptable reasons to deny the royalty payments under Section 32 of the Inland Revenue Act as amended?
No.

II. Did the Tax Appeal Commission err in law when it concluded that the sums relevant to this appeal did not fall within the ambit of Section 82(2) of the Inland Revenue Act as amended?
Does not arise as per the reasons given.

Accordingly, acting in terms of Section 11A (6) of the TAC Act, this Court confirms the TAC determination. The Registrar is directed to send a certified copy of this Judgment to the TAC.

Judge of the Court of Appeal

S.U.B. Karalliyadde, J

I agree

Judge of the Court of Appeal