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

In the matter of a Case Stated for the opinion of the Court of Appeal under Section 122(1) of the Inland Revenue Act No. 28 of 1979

**CA (Tax) Appeal No. 01/2007**

Ravindra Lalith Kumararatne,
No. 587/17, Thimbirigasyaya Road,
Colombo 5.

**APPELLANT**

Vs.

The Commissioner General of Inland Revenue,
Department of Inland Revenue,
Sir Chittampalam A. Gardiner Mawatha,
Colombo 2.

**RESPONDENT**

**Before:** **Arjuna Obeyesekere, J, / President of the Court of Appeal**
**Mayadunne Corea, J**

**Counsel:** Maithri Wickremasinghe, P.C., with S. Nadana Civa and Rakitha Jayatunga for the Appellant

Suranga Wimalasena, Senior State Counsel for the Respondent

**Argued on:** 23rd February 2021

**Written Submissions:** Tendered on behalf of the Appellant on 1st November 2019

Tendered on behalf of the Respondent on 4th November 2019

**Decided on:** 11th June 2021

**Arjuna Obeyesekere, J., P/CA**

The three questions of law that arise for the determination of this Court, which I will advert to in due course, revolve around the shares held by the Appellant in Forbes & Walker Limited (**FWL**) and whether the Appellant is liable for the payment of income tax that arises from the capital gains derived from a transaction in respect of the said shares.

This matter was taken up for argument together with CA (Tax) Appeal No. 4/2007 and CA (Tax) Appeal No. 6/2007. The learned President's Counsel appearing for the Appellant and the learned Senior State Counsel appearing for the Respondent submitted that the questions of law to be decided in this appeal are identical to the questions of law to be decided in the aforementioned CA (Tax) Appeal No. 04/2007 and CA (Tax) Appeal No. 06/2007 and that the parties in the said appeals are agreeable to be bound by the judgment that would be pronounced by this Court in this appeal.

The learned Counsel for both parties also agreed that the questions of law that should be answered by this Court are the first three questions of law set out in the motion dated 5th June 2015 tendered by the Appellant. The learned President's Counsel for the Appellant submitted that he would not be pursuing the fourth question of law set out in the said motion.[1]

Background facts

The Appellant in this case, together with the Appellants in the aforementioned cases, were Directors and shareholders of FWL. It is admitted that as at 20th October 1993, the Appellant held 88,242 shares in FWL, whilst the other two Appellants held 302,038 shares each in FWL.[2] Folio 7 of the 'Register of Members and Share Ledger' of FWL reflects:

(a) the name of the Appellant as the holder of 88,242 shares in FWL; and

(b) the distinctive numbers of the said 88,242 shares.

[1] The fourth question of law reads as follows: 'Did the Board of Review err in the hearing and determining the appeal consequent to the enactment of the Inland Revenue (Special Provisions) Act, No. 10 of 2003 and the subsequent enactment of the Inland Revenue (Regulation of Amnesty) Act No. 10 of 2004?'

[2] Vide letter dated 20th April 2005 issued by the Company Secretary of FWL.

The Appellant states that The Ondaatje Corporation of Canada (**TOC**) had made an 'Offer to Purchase' the total shareholding of all shareholders of FWL in exchange for shares and warrants in TOC (**the Offer**). I must note that a copy of the Offer, which is referred to in paragraph 1 of the Agreement dated 4th August 1993 (**the Agreement**) between TOC, FWL and four directors of FWL which includes the Appellants in all three appeals, collectively referred to as the 'Continuing Directors' in the said Agreement, has not been made available to the Board of Review.

Accordingly, all shares of FWL held by its shareholders including the shares held by the Appellant were transferred to TOC. The Appellant states further that he exchanged his 88,242 shares in FWL in return for 90,785 shares of TOC and a further 65,000 warrants of TOC. All other shareholders of FWL had similarly exchanged their shares in FWL for shares and/or warrants in TOC. It was the position of the Appellant that the only consideration that he received for the above transaction was the shares and warrants in TOC and that he did not receive any money. Folio 7 of the 'Register of Members and Share Ledger' of FWL reflects the above transfer of shares in favour of TOC under the heading *shares transferred* while the name of TOC has been entered as the entity that acquired the said shares of the Appellant in FWL.

The aforementioned transaction had taken place during the year of assessment 1993/94. In the computation sheet submitted together with his income tax return, the Appellant had only declared his income from employment, which was the total statutory income on which the income tax payable by the Appellant had been calculated. The Appellant had stated further under cage No. 5 which has been provided to declare capital gains that '*Forbes and Walker Limited merged with Ondaatje Corporation. No liability to capital gains in terms of Section 7(2)(f) as no monies were received*.' Thus, the position taken up by the Appellant in his return was that there was a merger between FWL and TOC and that as he did not receive any monies from the exchange of his shares in FWL with the shares and warrants of TOC, there was no capital gain and that he was therefore not liable for the payment of any income tax arising from this transaction.

Assessment issued to the Appellant

The Department of Inland Revenue, by letter dated 11th March 1997 under the caption, '*Year of Assessment 1993/94. Rejection of Return of Income*' informed the Appellant as follows:

> "*According to the letter of 24th September 1996 of M/s Ford Rhodes Thornton and Company (Chartered Accountants) authorised representative of M/s. Forbes and Walker Limited and the schedule attached thereto, you have transferred 43,300 number of shares you held in M/s Forbes and Walker Limited to M/s Ondaatje Corporation of Canada "TOC" on 21st October 1993.*
>
> *Further they have stated that 44,942 number of shares held by Corporate Services Limited with M/s Forbes and Walker Limited have been transferred to you on 20th October 1993.*
>
> *I note that according to the letter of Ford Rhodes Thornton and Company..., the entire Forbes and Walker shares were acquired by M/s Ondaatje Corporation of Canada "TOC" on 21st October 1993. This shows that you have transferred your entire Forbes and Walker shareholding during the year of assessment 93/94. You have not declared the Capital gain arising from this transaction which constitutes* ***change of ownership*** *of property. The Capital gain arising from this transaction in terms of* ***Section 7(1)(a)*** *read with Section 7(2)(a) and 7(3)(i)(ii) which is liable to tax should have been declared in your return of income for the year of assessment 93/94.*
>
> *For the reason given above, your return of income for the year of assessment 93/94 is rejected and an assessment will be raised accordingly*."

The Notice of Assessment dated 12th March 1997 was thereafter issued to the Appellant. While a sum of Rs. 35,605,336 has been set out as being the capital gains arising from the said transaction, the Appellant was directed to pay a sum of Rs. 11,095,980 as income tax and a further sum of Rs. 5,547,990 as surcharge. The breakdown of the calculation of the tax payable has been set out in the said Notice of Assessment.

Appeal to the Board of Review

Aggrieved by the said assessment served on him, the Appellant, by letter dated 25th March 1997, filed an appeal with the Commissioner General of Inland Revenue.[3] Acting in terms of Section 120 of the Inland Revenue Act No. 28 of 1979, as amended (**the Act**),[4] the Commissioner General by his letter dated 20th April, 1998 referred the appeal directly to the Board of Review.

The Board of Review, having afforded the parties a hearing as provided for in Section 121 of the Act, by its Determination dated 26th January 2007, confirmed the assessment and dismissed the appeal of the Appellant. Being dissatisfied with the determination of the Board of Review, the Appellant, by his letter dated 13th February 2007, made an application to the Board of Review under Section 122 of the Act to state a case to this Court on the questions of law set out in the said letter. The Board of Review had accordingly submitted the case stated on 24th April 2007 together with the questions of law, for the opinion of this Court.

Questions of Law to be decided by this Court

By a motion dated 5th June 2015, the Appellant submitted four questions as being the questions of law that needs to be determined by this Court. The learned Senior State Counsel for the Respondent did not have any objection to the said amended questions of law. As already observed, the Appellant is not pursuing with the fourth question of law, which leaves this Court to determine in this appeal the following three questions of law:

1. Did no profit or income as would be liable to income tax for capital gain within the meaning of the said terms in the Inland Revenue Act No. 28 of 1979 arise on the exchange of shares of the Appellant in Forbes & Walker Limited for shares and warrants in The Ondaatje Corporation?

[3] Section 117(1) of the Act

[4] Section 120 of the Act reads as follows: Notwithstanding the provisions of section 117, the Commissioner-General may refer any valid appeal made to him to the Board of Review, and the Board shall hear and determine such appeal, and accordingly, the provisions of section 121 shall apply to the hearing and determination of any appeal so referred.

2. Was no income tax for capital gain payable by the appellant on the exchange of shares of the appellant in Forbes & Walker Limited for shares and warrants in The Ondaatje Corporation?

3. Did the Board of Review err in determining the value of Shares?

Introduction of Capital Gains Tax into the Law of Sri Lanka

In the written submissions filed on behalf of the Appellant, the learned President's Counsel has traced the manner in which a tax payer became liable for the payment of income tax arising from capital gains on a transaction. He has pointed out that income tax was first introduced to Ceylon, as we were then known, in 1932 by the Income Tax Ordinance No. 2 of 1932 (**the Ordinance**). Section 5 of the Ordinance provided that income tax shall be charged for the year of assessment commencing on 1st April 1932 and for each subsequent year of assessment thereafter, on the profits and income of every person for the preceding year of assessment. Section 6 of the Ordinance contained the sources of income that were taxable under the Ordinance.

With the incorporation of the amendments that were introduced during the period 1932 to 1956, Section 6 of the Ordinance reads as follows: [5]

> "*For the purposes of this Ordinance, 'profits and income' or 'profits' or 'income' means –*
>
> *a) The profits from any trade, business, profession, or vocation for however short a period carried on or exercised;*
>
> *b) The profits from any employment;*
>
> *c) The net annual value of any land and improvements thereon occupied by or on behalf of the owner in so far as it is not so occupied for the purposes of a trade, business, profession, or vocation;*

[5] Vide Legislative Enactments of 1956.

*d) The net annual value of any land and improvements thereon used rent-free by the occupier which is not included in paragraphs (a), (b), or (c) of this subsection, or, where the rent paid for such land and improvements is less than the net annual value, the excess of such net annual value over the rent, to be deemed in each case the income of the occupier;*

*e) Dividends, interest, or discounts;*

*f) Any charge or annuity;*

*g) Rents, royalties, and premiums;*

*h) Income from any other source whatsoever, not including profits of a casual and non-recurring nature.*"

Thus, as at 1956, capital gains were not chargeable with income tax.

The learned President's Counsel for the Appellant submitted that the Parliament of Ceylon commissioned Nicholas Kaldor to study and propose comprehensive reforms of direct taxation that must be introduced into our tax regime. The Kaldor Report submitted in 1958 had proposed that, '*all profits which now rank as capital profit and, therefore, not liable to tax should henceforth be charged to income tax in the same way as a trading profit.*'[6] Consequent to the above recommendation, Parliament enacted the Income Tax (Amendment) Act No. 13 of 1959, through which capital gains as a source of taxable income was introduced by way of an amendment to Section 6 of the Ordinance.

The new Section, numbered as Section 6(1)(h), reads as follows:

"*For the purposes of this Ordinance, 'profits and income' or 'profits' or 'income' means*

*(h) net capital gains arising from-*

[6] The Kaldor Report has been published by the Parliament of Ceylon as Sessional Paper No. 4 of 1960; vide Chapter 1.

*(i) The change of ownership of any property occurring by sale, disposal, transfer, realisation, exchange, or in any other manner whatsoever, other than any such change of ownership of a fiduciary's rights in a property subject to a fideicommissum as occurs by a transfer or extinction of those rights, and other than a change of ownership of a right to exploit a property occurring by a transfer of that right and the change of ownership of a property the expenditure for the acquisition of which is assessable expenditure within the meaning of the Personal Tax Act of 1959 or would be such assessable expenditure if such acquisition were after the coming into operation of that Act,*

*(ii) The surrender or relinquishment of any right in any property other than the surrender of a life insurance policy,*

*(iii) The transfer of some of the rights in any property other than the transfer of the rights of a fiduciary in any property subject to a fideicommissum,*

*(iv) The loss of any office or employment,*

*(v) The redemption of any shares, debentures or other obligations,*

*(vi) The formation of a company,*

*(vii) The dissolution of a business, or the liquidation of a company,*

*(viii) The amalgamation or merger of two or more businesses or companies, or*

*(ix) Any transaction in connection with which a person who promotes that transaction without being a party to it receives any commission or reward,*

*on or after April 1, 1957, other than any such gains which are treated as profits or income under any other provisions of this section;*"

Having identified the specific types of transactions that gave rise to capital gains, the amendment went onto specify the manner in which capital gains are to be computed in respect of each of the said transactions. The provisions relating to capital gains that were introduced in 1959 continued into the Inland Revenue Act No. 28 of 1979 and thereafter, until capital gains were abolished by the Inland Revenue (Amendment) Act No. 10 of 2002.

Applicable provisions of the Inland Revenue Act No. 28 of 1979

I shall briefly refer to the provisions of the Act that are applicable to the present appeal.

In terms of Section 2(1) of the Act:

> "*Income tax shall, subject to the provisions of this Act, be charged at the appropriate rates specified in the First, Second and Third Schedules to this Act, for every year of assessment commencing on or after April 1, 1979, in respect of the* ***profits and income*** *of every person for that year of assessment-*
>
> *(a) wherever arising, in the case of a person who was resident in Sri Lanka in that year of assessment; and*
>
> *(b) arising in, or derived from, Sri Lanka in the case of every other person*."

Section 3 of the Act, which sets out the income that is chargeable with tax, reads as follows:

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

*(c) The net annual value of any land and improvements thereon occupied by or on behalf of the owner in so far as it is not so occupied for the purposes of a trade, business, profession or vocation;*

*(d) The net annual value of any land and improvements thereon used rent-free by the occupier if such net annual value is not taken into account in ascertaining profits and income under paragraphs (a), (b), or (c) of this section, or where the rent paid for such land and improvements is less than the net annual value, the excess of such net annual value, over the rent, to be deemed in each case the income of the occupier;*

*(e) Dividends, interest or discounts;*

*(f) Charges or annuities;*

*(g) Rents, royalties or premiums;*

*(h)* ***Capital gains****; and*

*(i) Income from any other source whatsoever, not including profits of a casual and non-recurring nature."*

Section 7(1) of the Act has specified the kind of transactions that give rise to capital gains as follows:

"*Capital gain" means the profits or income, not being profits or income within the meaning of paragraphs (a), (g) or (i) of section 3, arising from-*

*(a)* ***the change of ownership of any property occurring in any manner whatsoever***;

*(b) the surrender or relinquishment of any right in any property;*

*(c) the transfer of some of the rights in any property;*

*(d) the redemption of any shares, debentures or other obligations;*

*(e) the formation of a company;*

*(f) the dissolution of a business or the liquidation of a company;*

*(g)* ***the amalgamation or merger of two or more businesses or companies;*** *or*

*(h) any transaction in connection with the promotion of which any person who is not a party to such transaction receives a commission or reward."*

Accordingly, the profit or income arising from the transactions mentioned in paragraphs (a) – (h) are capital gains for the purpose of the Act.

The next section of the Act that is relevant is Section 7(2), which sets out what constitutes profits and income arising from the transactions specified in Section 7(1) for the purpose of charging income tax on the capital gains arising out of the said transactions.

Of the transactions referred to in Section 7(1), what is relevant to this appeal are paragraphs (a) and (g) of Section 7(1). While the Respondent claims that the above transaction is a change of ownership in the shares of FWL and comes within Section 7(1)(a), the Appellant claims that the said exchange of shares arose as a result of an amalgamation of FWL with TOC and therefore comes under Section 7(1)(g).

The provisions of Section 7(2) that correspond to Section 7(1)(a) and 7(1)(h), namely Section 7(2)(a) and Section 7(2)(f) respectively, are re-produced below:

| **Section 7(1)(a)** | **Section 7(2)(a)** |
|---|---|
| *The change of ownership of any property occurring in any manner whatsoever* | "*For the purpose of subsection (1) and in relation to the capital gain of any person, the profits and income arising from a change of ownership of property, means, subject to the provisions of sub-section (4), the amount by which the* ***value*** *of the property at the time when such change of ownership occurs exceeds its value at the time when it was acquired by that person*." |

| **Section 7(1)(h)** | **Section 7(2)(f)** |
|---|---|
| *The amalgamation or merger of two or more businesses or companies* | "*For the purpose of subsection (1) and in relation to the capital gain of any person, the profits and income arising from the amalgamation or merger of two or more companies, means, where such person was a shareholder of any of those companies,* ***any money received by such shareholder*** *in consequence of such amalgamation or merger, and where such person was not a shareholder of any of those companies, the value of the consideration received by him for any transaction in connection with such amalgamation or merger*." |

Thus, there are two matters that must be satisfied for a person to become liable for income tax on capital gains in terms of Section 3. The first is that the transaction giving rise to capital gains must be one which is referred to in Section 7(1). The second is that the profits and income arising from that transaction must come within Section 7(2).

<u>The position of the Respondent</u>

The Respondent has taken up the position that the said transaction is a sale of shares held by the Appellant in FWL to TOC and that there has been a change of ownership in such shares. Therefore, it was contended that the said transaction should fall under Section 7(1)(a) of the Act, i.e. *the change of ownership of any property occurring in any manner whatsoever*. The corresponding provision in Section 7(2), by which the capital gain that is liable for profits and income would be determined, is found in paragraph (a), to which I have already referred to.

The following facts are borne out by the 'Register of Members and Share Ledger' of FWL produced by the Appellant to the Board of Review, at the request of the Board of Review:

a) The Appellant has transferred the 88,242 shares held by him in FWL to TOC;

b) The name of TOC has been registered as the new owner of the said 88,242 shares in the Share Register of FWL; and

c) There has been a change of ownership of the said shares held by the Appellant,

Thus, it is clear that the transaction between TOC and the Appellant falls within Section 7(1)(a) of the Act.

It is also clear that Section 7(2)(a) does not require the receipt of "money" in order to determine the capital gain for the purpose of profits and income. Section 7(2)(a) is dependent on the amount by which the '*value of the property*' at the time when such change of ownership took place, exceeds its value at the time of the initial acquisition. The learned Senior State Counsel submitted that the intention of Parliament was to capture transactions not involving monetary consideration even in cases of amalgamation of two or more companies.

During the course of the hearing before the Board of Review, the Appellant submitted what the Appellant claimed to be the *Merger Agreement.* The Respondent states that the transaction contained in the said Agreement dated 4th August 1993 falls within the definition contained in Section 7(1)(a) because it satisfies the following two limbs of Section 7(1)(a), namely:

a) A change of ownership of property;

b) In any manner whatsoever.

It is the contention of the Respondent that according to the said Agreement, the sale of the shares held by the Appellant in FWL has given rise to a change of its ownership, which change of ownership, as I have already noted, has admittedly been entered in the 'Register of Members and Share Ledger' of FWL. The learned Senior State Counsel submitted that the manner in which the change of ownership occurs is irrelevant as long as the ownership has changed. The learned Senior State Counsel therefore argued that the need to disprove the position of the Appellant that the underlying transaction arises from an amalgamation of the two Companies does not arise because the said share transaction falls within the scope of the above provision.

The learned Senior State Counsel submitted that accordingly, there is no necessity for the receipt of money for the said transaction to constitute as capital gains, and that what must be determined and ascertained is the value of such property, *at the time of acquisition by the seller and at the time of selling by such seller*. He submitted further that the aforementioned Agreement itself refers to a "sale of shares", and that the capital gain in respect of such sale is liable to income tax.

I shall now refer to the Agreement referred to above, which the Attorney-at-Law for the Appellant had filed before the Board of Review with letter dated 25th April 2005. In terms of paragraph 14 thereof, the said Agreement '*constitutes the entire agreement and supersedes all prior agreements and understandings, both written and oral, between the parties with respect to the subject matter hereof*.'

Having examined the said Agreement in order to understand the true nature of the arrangement between TOC, FWL and the Appellant, I have re-produced below the clauses of the said agreement which confirms the submission of the Respondent.

Preamble –

> "*Whereas TOC and the Continuing Directors have been carrying on negotiations for the* ***purchase by TOC*** *of their respective shareholdings in FWL;*
>
> *Whereas the Continuing Directors have given an undertaking to TOC that the balance of the shareholdings in FWL held by each of the other shareholders (other than the holdings of D.H.T.Wijeyaratne and K.B.R.Perera) will be transferred to TOC;*[7]
>
> *Whereas the parties hereto are agreed that the terms and conditions as set forth in the document titled, '****Offer to Purchase****' relating to the outstanding ordinary shares of FWL and the appendices attached thereto, shall be incorporated by reference herein and shall form part and parcel and be integral to this Agreement*;

[7] TOC has entered into a separate agreement with K.B.R. Perera, which too has been marked as 'A8' and is dated 21st October 1993.

Paragraph 1 –

"*It is agreed by the parties hereto that the terms and conditions as set forth in the document titled, "**Offer to Purchase**" (the Offer) relating to the outstanding ordinary shares of FWL ("the Common Shares") and the appendices attached thereto and signed by the parties hereto for purposes of identification and annexed to this Agreement by way of Schedule sets out comprehensively terms and conditions pertaining to the **purchase by TOC** of the respective shareholdings of the Continuing Directors in FWL and is incorporated by reference herein and forms part and parcel of and is integral to this Agreement*."

Paragraph 3 -

"*The Continuing Directors **agree to sell** and TOC **agrees to purchase** that number of Common Shares of the Continuing Directors in FWL (the Continuing Directors' Shares) as set out hereunder, which shall constitute all of the Common Shares of each of the Continuing Directors:*

| | |
|---|---|
| *A.M.De S. Jayaratne* | *302,038* |
| *C.P.R.Perera* | *302,038* |
| *S.N.B.Wadugodapitiya* | *302,038* |
| *R.L.Kumararatne* | *88,242*." |

Paragraph 4 –

"*Subject to paragraph 5 hereof, the parties are agreed that as **consideration for the said sale** TOC shall allot to the Continuing Directors that number of common shares and common share purchase warrants of TOC (the "Shares" and "warrants" respectively) as are set out hereunder against each of the Continuing Directors*."

| | *Shares* | *Warrants* |
|---|---|---|
| *A.M.De S. Jayaratne* | *310,909* | *222,300* |
| *C.P.R.Perera* | *310,909* | *222,300* |
| *S.N.B.Wadugodapitiya* | *310,909* | *222,300* |
| *R.L.Kumararatne(Appellant)* | *90,785* | *65,000* |

Paragraph 6 –

> "*The Continuing Directors hereby undertake that all of the holdings of each of the undernoted shareholders of FWL will be transferred to TOC, prior to the completion of the* ***purchase*** *of the Continuing Directors' shares set out in paragraph 3 hereof, at the price set forth against names of each of the said holders.*"

Paragraph 8 –

> "*FWL and the Continuing Directors shall execute and do all such assurances and things as shall reasonably be required for the* ***completion of the sale.***"

There are three observations that I must make at this stage. The first is that the Appellant has not produced the "*Offer to Purchase*" document or any of the appendices referred to above. The second is that the Agreement speaks of a **sale of shares** by the Appellant(s) and the **purchase of shares** by TOC which was followed by a change of ownership. The third and the most important is that quite apart from the Agreement not containing any provision relating to 'amalgamation' or 'merger', the words, 'amalgamation' or 'merger' are nowhere to be found in the said Agreement. Thus, I am of the view that the said Agreement does not reflect any amalgamation or merger of FWL with TOC.

The Appellant had also submitted an agreement between TOC and K.B.R.Perera, who held 110,048 shares in FWL and a similar agreement between TOC and D. Wijeratne. In addition to the provisions in the previous agreement which I have already referred to, the above Agreements in their preamble refers to the said transaction as a ***share swap*** *between the shareholders of FWL and TOC as part of TOC's* ***proposed acquisition*** *of the entirety of FWL's share capital* and that K.B.R.Perera *has agreed to exchange or swap with TOC or its nominee the entirety of his holdings in FWL upon the terms and conditions set out hereunder.*

Thus, the argument of the learned Senior State Counsel that what took place was a sale of shares followed by a change of ownership of the FWL shares is borne out by the Share Register of FWL and the Agreement between TOC, FWL and the Appellant(s).

The position of the Appellant

The Appellant's position is that the transaction between TOC and FWL was an amalgamation, in terms of which TOC acquired all the shares of FWL and in return gave the said shareholders of FWL, shares and warrants in TOC. The Appellant submitted further that the share transaction in question had resulted in the assets of FWL coming under the control of TOC and that the resulting position was in effect a merger and/or an amalgamation of the two companies contemplated under the law. The Appellant has admitted that what took place was an exchange of shares from one company to another, or in other words, a share swap, but claims that the share swap was in consequence of an amalgamation or merger of FWL with TOC.

The Appellant's position therefore is that the said transaction of shares in fact comes under Section 7(1)(g) – i.e. '*the amalgamation or merger of two or more businesses or companies*'. While it was admitted that the profits and income arising from an amalgamation or merger would be capital gains liable for income tax, it was submitted further that in order to be liable for payment of capital gains arising from the said amalgamation/merger, there must be the receipt of money as stipulated in Section 7(2)(f). The Appellant claimed that no money was received and that the only consideration he received were shares and warrants in TOC.

In other words, it is the contention of the Appellant that while the transaction in question is an amalgamation or merger, it did not constitute profit or income within the provisions of Sections 2(1) and 3(h) of the Act, because no **money** was received by the Appellant during the transaction as required by Section 7(2)(f) of the Act. It was submitted that in the absence of the receipt of money, there was no capital gain and that the Appellant was not subject to income tax in terms of Sections 2(1), 3(h) and 7(1) of the Act.

Although the Appellant claimed that he did not receive any payment from TOC for the shares he held in FWL, the Appellant had tendered to the Board of Review a document titled 'Shareholder Trust' dated 21st October 1993, in terms of which TOC remitted Rs. 268.8m to a person referred to as the Global Trustee for distribution

among the shareholders of FWL, including the Appellant. Thus, the claim of the Appellant is contradicted by the above Trust document.

In response to the submission of the learned Senior State Counsel that the necessity to resort to Section 7(1)(g) does not arise when the transaction is already covered in Section 7(1)(a), the learned President's Counsel for the Appellant submitted that Section 7(1)(g) specifically applies to a situation where there is an amalgamation or merger of two or more businesses or companies and that in the presence of a specific provision, the general provision contained in Section 7(1)(a) read with Section 7(2)(a) will not apply.

Even if I accept the above argument of the learned President's Counsel, it still requires the Appellant to establish that the transaction between TOC and FWL was in fact an amalgamation, or that the impugned transaction arose in consequence of a merger or amalgamation of FWL with TOC. I am of the view that a correct identification of the nature of the transaction that took place between the Appellant and TOC would assist this Court to determine whether Section 7(1)(g) should apply to the aforementioned transaction.

Amalgamation

Neither the Act nor the Companies Act No. 17 of 1982 contains a definition of 'merger' or 'amalgamation'. However, several textual and judicial authorities which discuss certain basic features of amalgamations and mergers may be used to provide interpretative guidance for the purposes of the present appeal.

In '**Principles of Modern Company Law**' by Gower and Davies,[8] it has been stated as follows:

> "*The shareholders of the merging companies will end up as shareholders in the "resulting company" (which may be a new company formed for the purpose of the merger or one of the merging companies), each of the previously separate bodies of shareholders holding, more or less, the proportion of shares in the resulting company which reflects the respective valuations of the companies*

[8] Gower and Davies, Principles of Modern Company Law (8th Edition, 2008), Sweet & Maxwell, page 1059-1060.

*which came together to form that company. The implementation of a merger normally requires the consent by resolution of the shareholders of the companies involved and of their boards of directors. Thus* ***a merger involves a corporate decision taken on behalf of each of the companies adopting the merger plan***."

In **Company Law**[9] by Kanag-Isvaran and Wijayawardana, it has been stated that:

"*The word 'amalgamation' has no definite legal meaning. It contemplates a state of things under which two companies are so joined as to form a third entity, or one company is absorbed into and blended with another company. An important element of the concept of amalgamation is that the amalgamating companies do not die. All the assets, rights and liabilities of the amalgamating companies flow into the amalgamated companies, as opposed to the transfer of assets, rights and liabilities. They simply become the assets and liabilities of the amalgamated company.*

*...*

*For legal purposes, when upon amalgamation two or more companies 'continue as one company', it is generally recognized that the amalgamating companies do not cease to exist but continue, and that the amalgamated company is not a new company. This metaphysical process has been explained by the analogy of streams coming together to form a river and strands of fibre intertwined to form a rope*."

The legal effect of an amalgamation has been described by the Indian Supreme Court in **Saraswati Industrial Syndicate Ltd., v. C.I.T. Haryana, Himachal Pradesh, Delhi-III, New Delhi,** as follows:[10]

"*Generally, where only one company is involved in change and the rights of the share holders and creditors are varied, it amounts to reconstruction or reorganisation or scheme of arrangement. In amalgamation two or more companies are fused into one by merger or by taking over by another. Reconstruction or 'amalgamation' has no precise legal meaning.* ***The amalgamation is a blending of two or more existing undertakings into one***

[9] K. Kanag-Isvaran and Dilshani Wijayawardana, Company Law (2014), p 581-582.
[10] 1991 AIR SC 70 at 72.

***undertaking, the share holders of each blending company become substantially the share holders in the company which is to carry on the blended undertakings.*** *There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertakings to an existing company.****"***

According to **Halsbury's Laws of England**:[11]

"*Amalgamation is the blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company* ***which will carry on the blended undertakings****. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertakings to an existing company.* ***Strictly 'amalgamation' does not, it seems, cover the mere acquisition by a company of the share capital of other companies which remain in existence and continue their undertakings, but the context in which the term is used may show that it is intended to include such an acquisition.***"

The above authorities illustrate that there are several key features that define an amalgamation or merger. What is critical is that a mere share swap or exchange of shares does not qualify a transaction to be an amalgamation of the two companies concerned. In other words, an acquisition of shares does not amount to amalgamation. The most basic feature is that there must be a blending of the two companies into one, usually as a result of a corporate decision taken on behalf of each company in consultation with its shareholders. While the corporate decision would include issues such as valuation of the shares of the two entities and which entity would forge ahead with the undertaking, the agreement between the parties must reflect a true blending of the two companies and must not be a transaction to evade the payment of taxes.

[11] Halsbury's Laws of England, 5th Edition, Volume 15A, Para 1615.

The Agreement – revisited

The only way this Court can determine the nature of the transaction is through the documents that have been produced by the Appellant, to which I have already referred to in detail, which establishes that there has been a change of ownership in the shares of FWL.

Here was an arrangement where the entire shareholding of FWL, including the shares that the Appellant had acquired over a long period of time, was being sold to a Canadian Company. If, as claimed by the Appellant, no money was coming into their hands, the Appellant was going to risk it all by entering into an arrangement over which he had no control. If it was a true amalgamation, FWL as a Company and the Appellant as a Director thereof would surely have carried out a feasibility study of the proposed amalgamation as well as a due diligence study of the said arrangement and the creditworthiness of TOC. No evidence has been produced by the Appellant that FWL had engaged in such an exercise, nor has the Appellant produced the 'Offer to Purchase' document and the appendices thereto, which may have shed light, either way

Furthermore, an amalgamation would have required the approval of the shareholders of FWL by way of a shareholders resolution. While no such resolution has been made available to the Board of Review, paragraph 6 of the Agreement by which the Appellant and the other three Continuing Directors have undertaken to obtain the consent of the other shareholders makes it clear that there was no resolution by the shareholders approving the above sale and purchase of shares.

Even if one accepts the fact that the Appellant chose to take all the risks, the Agreement itself does not contain any intention on the part of TOC, FWL and the Appellant to carry out an amalgamation of FWL with TOC or merger of the two companies. Having examined the said Agreement and the clauses thereof to which I have already adverted to, it is clear to me that the said agreement is an agreement for the sale and purchase of shares[12] which resulted in the TOC being registered as the owner of the shares held by the Appellant in the Register of FWL. Nowhere in the agreement does it contain any provision that suggests a blending of FWL with

[12]Referred to as such in many paragraphs in the said Agreement: 3, 4, 8, 13(a).

TOC or as noted earlier, *two streams coming together to form a river or two strands of fibre intertwined to form a rope*.

Even the undertaking in paragraph 7 of the Agreement that a sum not less than USD 3m will be transferred to FWL has not been supported with any evidence that such a remittance was in fact made.

As illustrated above, there are several legal and practical considerations associated with the amalgamation of two Companies which this Agreement does not clearly reflect. Although the Companies Act No. 17 of 1982, as amended, did not contain detailed provisions relating to amalgamation and only provided the mechanism to effect a change to the Memorandum arising from an amalgamation or a Court mandated amalgamation, the present Companies Act No. 7 of 2007 contains a complete Chapter on amalgamations. Although the provisions of Act No. 7 of 2007 are not applicable to the present transaction, a perusal of the Sections would be beneficial in ascertaining the complexities associated with the amalgamation of companies.

While Section 239 requires public notice of an amalgamation to be given in accordance with the provisions of the said Act, Section 240 describes that every company that proposes to amalgamate shall approve an amalgamation proposal containing all the details contained in the said provision, including the name of the amalgamated company, share structure, place of business, proposed articles of amalgamated company etc. Section 241 dictates that the abovementioned proposal is to be made only on approval being granted by the boards of the amalgamating companies that amalgamation is in the best interest of all companies. Section 241(5) specifically states that an amalgamation may only be effected if the amalgamation proposal is approved by a special resolution of the shareholders of each company in accordance with Section 92 and if required, approval being granted by special resolution of a special interest group where the amalgamation proposal would alter the rights of that special interest group. It is only upon registration of the documents specified under Section 243 with the Registrar of Companies, that a Certificate of Amalgamation as specified under Section 244 would be issued.

The purpose of discussing the abovementioned provisions contained in the Companies Act 2007, although not relevant to the present appeal, was to illustrate that the legal regime governing the amalgamation of companies is a complex procedure and not one which could be ***inferred*** from a mere exchange of shares between parties.

The Appellant has failed to produce any factual and substantial evidence to support the amalgamation that it claims of the said Companies, by way of Board Resolutions, Annual Reports, Amendments to Articles of Association or other official documents which should contain an explicit statement of such. Had the two Companies in question, FWL and TOC, intended for there to be an amalgamation or merger of the two companies, there would be an express and unambiguous articulation of such intention. An amalgamation or merger cannot occur without the parties expressing their intention to enter into a well defined scheme of amalgamation.

In the written submissions produced before the Board of Review, the Appellant had stated that, '*FWL was a Sri Lankan company with its distinct know how on stock broking and other expertise on local produce. TOC the acquirer was an investment company with no such knowledge of local conditions. In fact after the merger the appellant with the other former directors, excluding one, continued to run FWL. Only minimally did an officer from TOC get involved in the control of FWL.*' These are hardly the circumstances that would follow an amalgamation.

In these circumstances, the contention of the Appellant that the said transaction is an amalgamation of FWL with TWC cannot be accepted. The result is that the Appellant cannot classify the said transaction under Section 7(1)(g) of the Act.

Should one of the two companies be wound up to prove the existence of an amalgamation?

The Board of Review has taken the view that according to the Sri Lanka Accounting Standard No. 25, an amalgamation contemplates the dissolution of the transferor company without winding up and that in a takeover, shares are acquired in order to

get controlling interest. The Board of Review has relied on the case of **Re Walker's Settlement**[13] in support of this position.

The learned President's Counsel for the Appellant drew the attention of this Court to the judgment in **Crane-Fruehauf v Inland Revenue Commissioners**[14] in support of his contention that the transferor company need not be wound up to prove the existence of an amalgamation of the two companies. In view of the conclusions that I have already reached, I am of the view that the necessity to go into this issue does not arise.

Value of the shares

The final question to be determined by this Court is whether the Board of Review erred in determining the value of the FWL shares held by the Appellant.

In terms of Section 7(2)(a), '*For the purpose of subsection (1) and in relation to the capital gain of any person, the profits and income arising from a change of ownership of property, means, subject to the provisions of sub-section 4, the amount by which the* ***value*** *of the property at the time when such change of ownership occurs exceeds its value at the time when it was acquired by that person*."

It is the position of the Respondent that the requirement under this provision is for the assessor to ascertain the value of the shares at the time of acquisition and at the time of sale of the shares and that the difference in value between the two would be the capital gain, which would be the profits and income that would be liable to income tax in terms of the Act.

The aggregate cost of the acquisition of the shares held by the Appellant has been determined as Rs. 1,103,336 in the following manner:

| | | |
|---|---|---|
| 7500 shares at Rs. 5 per share | = | Rs. 37,500 |
| 20000 shares at Rs. 10 per share | = | Rs. 200,000 |
| 15800 shares at Rs. 10 per share | = | Rs. 158,000 |
| 44942 shares at Rs. 15.75 per share | = | Rs. 707,836 |

[13] CA 1935 Ch.D 567
[14] [1975] 1 All ER 429.

The Appellant did not produce any material to the Board of Review to contradict the above figures, which led the Board of Review to conclude that *no evidence has been placed before the Board by the Appellant or Revenue to prove that the market value in fact was less than Rs. 416 per share.*

The Respondent states that for the purpose of determining the value of a share of FWL at the time of sale, the assessor obtained the market value of a share of FWL on the basis of a similar transaction with TOC by another Director of FWL. In his appeal against the assessment, the Appellant had only stated that, '*I wish to state that the estimated market value of the shares of Rs. 416 per share in your computation annexed to your letter under Section 115(3) aforementioned, is incorrect and excessive*'. No reasons have been adduced by the Appellant as to why it is incorrect or excessive. The Respondent states that other than disputing the computation of the said amount, the Appellant had not produced any documents to prove that such computation is flawed. Therefore, the Respondent has submitted that the value of the shares that were sold by the Appellant to TOC was correctly arrived at by the Assessor and the Board of Review, as Rs. 416 per share, and the tax liability calculated was arrived at correctly.

In the above circumstances, I am in agreement with the conclusion reached by the Board of Review.

<u>Conclusion</u>

Taking into consideration all of the above circumstances, I am of the following view:

a) The Agreement between TOC, FWL and the Continuing Directors only provide for the sale and purchase of shares in FWL and the consequent change of ownership in the said shares;

b) What has taken place is a change of ownership of shares held by the Appellant in FWL, as provided in Section 7(1)(a);

c) The Appellant has not produced any evidence to prove the existence of an amalgamation or merger of FWL with TOC;

d) The Agreement shows no intention between the parties to carry out an amalgamation or merger between the companies.

e) Even if the Appellant did not receive any money in the said transaction, that is irrelevant in view of the conclusion reached that there is no amalgamation or merger.

For the foregoing reasons, the three questions of law posed to this Court are answered as follows:

1) Did no profit or income as would be liable to income tax for capital gain within the meaning of the said terms in the Inland Revenue Act No. 28 of 1979 arise on the exchange of shares of the Appellant in Forbes & Walker Limited for shares and warrants in The Ondaatje Corporation?

   The transaction between TOC, FWL and the Appellant resulted in a change of ownership of the shares held by the Appellant in FWL in favour of TOC. The said transaction therefore falls within Section 7(1)(a) read together with Section 7(2)(a) of the Act. As profits and income arose on the said transaction, the Appellant is liable for the payment of income tax arising from the capital gains derived from the said transaction.

2) Was no income tax for capital gain payable by the appellant on the exchange of shares of the appellant in Forbes & Walker Limited for shares and warrants in The Ondaatje Corporation?

   The Appellant is liable for the payment of income tax arising from the capital gains derived from the sale of his FWL shares to TOC.

3) Did the Board of Review err in determining the value of Shares?

   No. The determination of the value of shares by the BOR can be accepted in the absence of any material to dispute the computation of the assessor.

Accordingly, this Court confirms the assessment determined by the Board of Review.

This appeal is therefore dismissed, without costs.

The Registrar is directed to send a certified copy of this judgment to the Secretary, Tax Appeals Commission.

**President of the Court of Appeal**

**Mayadunne Corea, J**

I agree

**Judge of the Court of Appeal**