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

In the matter of an appeal by way of Stated Case on a question of law for the opinion of the Court of Appeal under and in terms of Section 11A of the Tax Appeals Commission Act, No. 23 of 2011 (as amended).

Samson Rajarata Tiles (Pvt) Ltd,
DSI Complex, 251, Navinna,
Maharagama.

APPELLANT

CA No. CA/TAX/0008/2015
Tax Appeals Commission
No. TAC/IT/023/2013

v.

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

RESPONDENT

BEFORE : Dr. Ruwan Fernando J. &
M. Sampath K. B. Wijeratne J.

COUNSEL : Riad Ameen with Rushitha Rodigo for the Appellant.

Sumathi Dharmawardena, PC, ASG with A. Gajadeera, SC for the Respondent.

WRITTEN SUBMISSIONS	:	30.10.2018 & 28.03.2023 (by the Appellant) 07.09.2018 & 28.04.2023 (by the Respondent)
ARGUED ON	:	02.02.2023 & 10.02.2023
DECIDED ON	:	30.05.2023

M. Sampath K. B. Wijeratne J.

Introduction

The Appellant, Samson Rajarata Tiles (Pvt) Ltd (hereinafter referred to as 'Samson Tiles') is a limited liability company incorporated in Sri Lanka. The business of the Appellant company is manufacturing and exporting roofing tiles and floor tiles.

The Appellant Company borrowed short-term loans from DSI Samson Group (Pvt) Ltd (hereinafter referred to as 'DSI'). The Appellant submitted its return of income for the year of assessment 2008/2009[1] claiming deductions for interest expenses during the year of assessment 2008/2009, under Section 25 (i)(f) of the Inland Revenue Act No. 10 of 2006 (hereinafter referred to as the 'IR Act'). The Assessor by his letter dated 30th December 2010 issued in terms of Section 163 (3) of the IR Act rejected the return of income submitted by the Appellant[2]. Thereafter, the Assessor proceeded to issue the Notice of Assessment dated 29th August 2011[3].

The Appellant company lodged an appeal with the Commissioner General of Inland Revenue (hereinafter referred to as the 'CGIR') against the assessment. The CGIR heard the appeal and made his determination on the 3rd April 2013[4] holding that the Appellant company is not eligible to deduct interest expenses. Accordingly, the assessment was confirmed.

[1] At page 52 of the appeal brief.
[2] At page 117/132 of the appeal brief.
[3] At page 25 and 114 of the appeal brief.
[4] At page 01 of the appeal brief.

Being aggrieved by the determination of the CGIR the Appellant company appealed to the Tax Appeals Commission (hereinafter referred to as the 'TAC'). The TAC made its determination on the 06th January 2015 confirming the determination made by the CGIR[5].

The aggrieved Appellant moved the TAC to state a case to this Court on eleven questions of law. However, on the 19th of January 2023, of consent, both parties suggested the following three questions of law for the opinion of this Court.

1. ***Is it Samson Footwear (Pvt) Ltd, or is it DSI Samson Group (Pvt), that is the holding company of the Appellant within the meaning of Section 26(1) (x) of the Inland Revenue Act No. 10 of 2006?***

2. ***In view of the requirement in Section 26(1) (x) of the Inland Revenue Act No. 10 of 2006 to consider the issued share capital and "reserves", can a negative Retained Earnings/ Accumulated Loss/ Deficit be considered as "reserves"?***

3. ***Did the commission err in law in accepting as correct the computation made by the assessor of "excess" referred to in section 26 (1) (x) which computation is contrary to the provision in Section 26 (1) (x) in that the assessor has taken into account a "deficit" which is not referred to in the provision?***

Analysis

For clarity, I will first reproduce the relevant statutory provisions.

The Appellant company deducted the interest paid on loans under Section 25 (i)(f) of the IR Act.

Section 25 (i)(f) reads as follows;

> **25 (1)** *Subject to the provisions of subsections (2) and (4), there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof, including-*
>
> *(a) to (e) (...)*

[5] At page 190 of the appeal brief.

(f) interest paid or payable by such person;

(g) to (y) (...)

The Assessor disallowed the deductions sought by the Appellant pursuant to Section 26 (1)(x) of the IR Act which reads 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-*

(a) to (w) *(...)*

(x) ***the excess, If any,*** *of the aggregate amount of the interest payable for any year of assessment by any subsidiary company (hereinafter referred to as the first mentioned subsidiary company) of any holding company, in respect of any loan obtained from such holding company or any other subsidiary company or subsidiary companies (hereinafter referred to as the second mentioned subsidiary company or subsidiary companies), over such part of the interest so payable, as is attributable to such part of such loan,* ***as is equal to thrice the aggregate of the issued share capital and reserves*** *at the end of that year of assessment of the first mentioned subsidiary company, where such first mentioned subsidiary company is a manufacturer.*

Provided that where such first mentioned subsidiary company is not a manufacturer the provisions of the preceding paragraph shall apply as if for the reference in that paragraph to the words "thrice the aggregate of the issued share capital and reserves", there were substituted a reference to the words "four times the aggregate of the issued share capital and reserves".

(i) the expressions "subsidiary company" and "holding company" shall have the same respective meanings assigned to them in the Companies Act, No. 17 of 1982;

(ii) the first mentioned subsidiary company shall, in relation to any year of assessment, be deemed to be "a

manufacturer", if more than fifty per centum of the turnover for that year of assessment of such subsidiary company, is from the sale of products manufactured by such subsidiary company;

(iii) (...)

(iv) (...)

(Emphasis added)

'Subsidiary company' is defined in Section 529 of the Companies Act No. 7 of 2007 so as to mean *inter-alia* a '*company in which the other company holds more than half of the issued shares of the first mentioned company.*

'Holding company' is defined in Section 529 of the Companies Act No.7 of 2007 as follows;

'a company shall be deemed to be another company's holding company, if and only if that other company is its subsidiary. For the purpose of this definition "company" includes anybody corporate; '

1. ***Is it Samson Footwear (Pvt) Ltd, or is it DSI Samson Group (Pvt), that is the holding company of the Appellant within the meaning of Section 26(1) (x) of the Inland Revenue Act No. 10 of 2006?***

A duction claimed in respect of interest paid on a loan can be denied under Section 26 (1)(x);

i. if the loan is taken from the holding company of the Appellant company or,

ii. if the loan is taken from a subsidiary of the holding company, of which the Appellant company is a subsidiary.

The Appellant argued that in the instant case, both aforementioned conditions are not present.

As I have already stated above the Appellant company borrowed loans from DSI. This is an admitted fact and therefore, the central issue is whether DSI is the holding company of the Appellant or a subsidiary of the holding company of the Appellant.

According to the Appellant, DSI is neither the holding company of the Appellant nor a subsidiary of the holding company of the Appellant and Samson Footwear Limited (hereinafter referred to as 'Samson Footwear') is the holding company of the Appellant.

In support of the above fact the Appellant submitted;

1. Annual return (form 15) of the Appellant filed on 14th January 2009[6].

2. A document setting out the share structure of the Appellant as of 31st March 2009[7].

3. Share certificate of the Appellant in respect of 3,180,000 shares issued to Samson Footwear.

4. An extract of minutes of the meeting of the Directors of D. Samson and Sons Ltd dated 1st April 2005 with regard to the sale of 3,180,000 shares of Samson Tiles to Samson Footwear.

5. An extract of minutes of the meeting of the Directors of D. Samson Industries Limited dated 1st April 2005 with regard to 8,800,000 shares of Samson Tiles sold to Samson Footwear[8].

As evident from the above-mentioned documents, the Appellant submitted that Samson Footwear acquired shares of the Appellant company in the following manner, on the 1st April 2005.

a. From Samson Industries Ltd.	8,800,000
b. From D. Samson and Sons Ltd.	3,180,000
c. From Lanka Ventures	3,000,000
	14,980,000

Samson Industries Ltd. and D. Samson and Sons Ltd. are from the same group of companies but, Lanka Ventures is not.

The Appellant submitted that D. Samson Industries and D. Samson and Sons (Pvt) Ltd transferred their shares to Samson Footwear for justifiable commercial reasons. DSI granted a large amount of loans to the Appellant and the Appellant incurred huge losses and could not repay the loans.

[6] P. 149 of the appeal brief.
[7] P. 76 of the appeal brief.
[8] P. 101 of the appeal brief.

Therefore, the loans were converted into shares in favour of DSI[9]. However, the Appellant has made a contradictory submission[10] that Samson Footwear obtained financial Assistance to purchase shares in the Appellant. As it was submitted by the Respondent, the TAC has correctly observed that DSI and D. Samson and Sons Limited resolved to sell their 88,000.00 and 31,080.00 shares of Samson Tiles to Samson Footwear, and the consideration was provided by those two companies themselves.

According to the Appellant, after the loans were converted into shares in favour of DSI, the accounts of the Appellant and DSI had to be consolidated in terms of Sri Lanka Accounting Standards Number 26. However, if it was done the losses of the Appellant would have affected the business activities and the credit rating of DSI. Therefore, it was decided to transfer the shares to Samson Footwear to avoid the negative impact. As I have already stated above in this judgment, the number of shares shown in Form 15 of the Appellant, in the name of Samson Footwear is 14,980,000. The said amount is worked out as stated above in this judgment. It was the shares of D. Samson Industries Limited, D. Samson and Sons Limited, and Lanka Ventures that were transferred to Samson Footwear. I can understand D. Samson Industries Limited and D. Samson and Sons being members of the same group of companies transferring their shares for justifiable commercial reasons, as stated by the Appellant[11]. But the number of shares 14,980,000 includes shares of Lanka Ventures as well, a company not from the same group of companies.

I am unable to understand why Lanka Ventures also transferred their shares to Samson Footwear and what was the justifiable commercial reason for Lanka Venture to do so. This creates serious doubt about the authenticity of the documents submitted by the Appellant in support of their contention.

In my view, the Appellant should have filed annual account statements of D. Samson Industries Limited, D. Samson and Sons Ltd, and DSI to substantiate the Appellant's explanation regarding the aforementioned transfer of shares. In fact, the CGIR has called for these documents[12] by letter of the Deputy Commissioner dated 12th March 2013[13]. However, the Appellant has failed to oblige. Consequently, the CGIR affirmed the assessment made by the Assessor, based on the notes of the accounts of

[9] At paragraphs 36, 37 and 44 of the Appellant's written submissions dated 30th October 2018.
[10] Ibid at paragraphs 116 to 120.
[11] At paragraph 42 of the appeal brief.
[12] At paragraph 53 of the Appellant's written submissions file on the 30th October 2018.
[13] Page 126 of the appeal brief.

DSI wherein it is stated that the Appellant is a subsidiary of DSI. The Appellant submitted that the above statement in the notes of accounts was a misstatement and it was subsequently corrected. Further, it was submitted that it is not appropriate for the CGIR to use another company's accounts statement. However, in my view, it is lawful for the Assessor to obtain information from the account statement of another company[14]. The Appellant stated that the reference in the notes to the accounts of the DSI to the effect that the Appellant is a subsidiary of DSI was subsequently corrected. However, it was an account statement certified by chartered accountants. In my view, on the whole of the facts submitted to the Court which I have analysed above, it cannot be regarded as an inadvertence.

The Appellant stated that the TAC misdirected itself by referring to the above accounts as of the Appellant whereas those were of DSI. In the account statement of DSI, Samson Tiles is stated to as a subsidiary of DSI. The concern of the TAC was whether the Appellant is a subsidiary of DSI or not. The Appellant has failed to substantiate the fact that it is a misstatement by producing acceptable evidence such as share registers of the relevant companies. Therefore, the above misstatement in the determination of the TAC has not affected the final conclusion of the TAC.

The Appellant also submitted that the observation of the TAC to the effect that Samson Footwear was defunct and inactive and has not paid income tax from 2003 is irrelevant and extraneous consideration by the TAC. I do agree that those facts are irrelevant to the determination as to whether Samson Footwear is the holding company of the Appellant or not. Yet, there are sufficient other considerations to arrive at the conclusion the TAC did. Therefore, in my view, the above fact has not influenced the conclusion of the TAC. It was also submitted that the fact whether a company is a holding company or not cannot be decided on an audit report. I concede the above submission of the Appellant. Yet, as I have analysed in this judgment, there are sufficient other considerations to hold that DSI is the holding company of the Appellant. Further, it was submitted that there is no basis for the TAC to disregard the annual return of the Appellant and the share certificate issued by the Appellant to footwear. However, on the Appellant's own admission, the shares were issued to Samson Footwear in contravention of Sri Lanka Account Standards No. 26[15] to avoid a negative impact on DSI[16]. Therefore, the entry in the annual return

[14] M. Weerasooriya and E. Gooneratne, *Income Tax in Sri Lanka*, 2nd Edition, 2009 at 424.
[15] At paragraph 42 (iv) of the Appellant's written submission filed on the 30th October 2018.
[16] Ibid at paragraphs 42 (v) to (ix).

is also questionable on the same basis. In terms of Section 131 of the Companies Act[17], every company has to submit an annual return at least once every year, including *inter alia* the details of its shareholding. Under Section 123, every company that has issued shares should maintain a share register. Section 130 provides that the entry of the name of a person in the share register as holder of a share shall be *prima facie* evidence that the title to the share is vested in that person. But there is no presumption of that kind for the annual report. It is therefore apparent that the Appellant failed to produce the most essential documents in support of its claim. I am aware that the burden is on the taxpayer to disprove the correctness an assessment. Although the dispute may be on the reasons given by the Assessor for rejecting the return and making an assessment, yet, the onus of disproving the estimate lies on the tax payer. In my view, the Appellant has failed in this instance to disprove the assessment. Therefore, I am of the view that, based on the available evidence, the TAC is justified in holding that DSI is the holding company of the Appellant.

Therefore, in light of the available evidence, for the limited purpose of this case I answer the first question of law that it is DSI Samson Group (Pvt) Ltd is the holding company of the Appellant within the meaning of Section 26 (1)(x) of the IR Act.

2. ***In view of the requirement in Section 26(1) (x) of the Inland Revenue Act No. 10 of 2006 to consider the issued share capital and "reserves", can a negative Retained Earnings/ Accumulated Loss/ Deficit be considered as "reserves"?***

3. ***Did the commission err in law in accepting as correct the computation made by the assessor of "excess" referred to in section 26 (1) (x) which computation is contrary to the provision in Section 26 (1) (x) in that the assessor has taken into account a "deficit" which is not referred to in the provision?***

The learned Counsel for the Appellant made submissions on the application of Section 26 (1)(x) to the holding companies and their subsidiaries.

According to the Appellant, the limitation of the quantum of deductible interest provided in Section 26 (1)(x) is a well-known theory called *thin capitalization*. The Appellant explained the objective of the Rule as follows.

[17] No. 7 of 2007.

It was submitted that there is a risk that a holding company may invest less share capital in a subsidiary and instead, give more loans to a subsidiary. This will result in a larger interest expense for the subsidiary on the loans taken from the holding company. The risk is avoided by limiting the amount of interest that can be deducted as interest on loans. As such Section 26 (1)(x) limits the interest deductible to three times the sum equal to the share capital and reserves of the subsidiary. Anything more in the form of interest is not deductible under Section 26 (1)(x).

Admittedly, the share capital of the Appellant of Rs. 263,812,452.39[18]. According to the Appellant, the Appellant did not have any reserves since it had been making accumulated losses. Under Section 26(1)(x), the Appellant is allowed to deduct the interest payable on loans up to three times its share capital of 263,812,452.39. Three times this amount is 791,437,357.17. The Appellant submitted that according to the Assessor himself, the loans taken from all the related companies were Rs. 530,395,372.53[19]. Accordingly, the Appellant submitted that the Appellant is entitled to deduct the interest payable on the above amount of 530,395,372,53 since it is below the upper limit allowed in Section 26 (1)(x).

The Respondent's argument is that accumulated losses amounting to Rs. 737,014,909.22 constitutes a negative retain earning and should be treated as a reserve. The Appellant disputed this position. The Assessor has worked out the difference between the negative retained earnings (accumulated losses) amounting to 737,014,909.22 and the issued share capital of Rs.263,812,452.39 as equity of Rs. 437,202,456,83[20]. Therefore, the issue to be determined by this Court is whether the negative retain earnings (accumulated losses) constitute a reserve. The term reserve is not defined in the IR Act. Section 26 (1)(x)(iii) only states that '*reserves' do not include reserves from the revaluation of any asset'*. The Appellant cited the Black's Law Dictionary[21] where the term *reserve* is defined to mean *'to keep back, retain, keeping, store for future or special use, and to retain or hold over to future time'*.

Accordingly, it was argued that reserve can never be negative.

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[18] Assessor's letter dated 30th December 2010 at p. 58 of the appeal brief.
[19] The total loan amounts stated in Assessor's letter dated 30th December 2010 at p. 59 of the appeal brief.
[20] At p. 58 of the appeal brief.
[21] *Black's Law Dictionary,* 6th Edition at p.1307.

The Appellant argued that the word '*excess*' in Section 26 (1)(x) makes it clear that a certain sum is always deductible as interest and only the excess is disallowed.

The Appellant also stated that a '*provision*' is distinct from a '*reserve'*. In support of this contention, the Appellant cited the Indian judgment of *Bazir Sultan to Bacco Co. Ltd v. Commissioner of Income Tax*[22]. However, the Respondent stated that this was a case where the Indian Supreme Court interpreted the terms in the Companies Act of 1956 and therefore, irrelevant to the issue at hand.

In my view, although the term reserve is not specially defined within the IR Act, being a general term, the Court need not rely on Indian authorities to define the term reserve. It could be defined within the IR Act itself as a general term.

Another argument advanced by the Appellant is that the Assessor and the TAC both erred in using 'equity' in arriving at their conclusion. The Appellant submitted that Section 26 (1)(x) only refers to *share capital* and *reserves* and does not refer to *equity*. As it was submitted by the Appellant, in terms of Sri Lankan Accounting Standards 2006[23], equity is calculated by adding share capital, reserves, retained earnings, and minority interests. The Assessor has correctly computed *equity* on this basis[24]. However, as it was correctly submitted by the Appellant equity is irrelevant to Section 26 (1)(x).

In light of the above analysis, I am inclined to accept the submissions made by the Appellant that negative retained earnings (accumulated losses) cannot be treated as a reserve.

Therefore, in light of the above analysis I answer the second question of law in the negative and the third questions of law in the affirmative in favour of the Appellant.

Conclusion

I find that the findings made by the TAC in respect of the second and third questions of law are erroneous. Yet, I agree with the finding of the TAC on the first question of law.

[22] [1981] AIR 2015, 1982 SCR (1) 789.

[23] SLAS 3 at p.102.

[24] At p. 58 of the appeal brief.

Thus, having considered all arguments presented to this Court by both parties, for the reasons set out above in this judgement I answer the questions of law raised in this case as follows.

1) ***It is DSI Samson Group (Pvt) Ltd is the holding company of the Appellant within the meaning of Section 26 (1)(x) of the IR Act.***

2) ***No.***

3) ***Yes.***

In light of the answers given to the second and third questions of law, acting under Section 11A (6) of the TAC Act, I remit to case to the TAC with the opinion of this Court that the assessment be revised accordingly.

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

JUDGE OF THE COURT OF APPEAL

<u>Dr. Ruwan Fernando J.</u>

I Agree.

JUDGE OF THE COURT OF APPEAL