

## Direct Tax Alert

April 18, 2023



# Supreme Court determines residential status of company based on de-facto control and management

Supreme Court dismissed taxpayers' appeal<sup>1</sup> holding that companies incorporated and registered in Sikkim were in essence 'resident' in India in view of their de facto control and management exercised in India. The domicile or registration of the company in a particular state/country is not relevant. The Supreme Court held that the determinate test for determining the residential status is where the sole right to manage and control of the company lies. The ruling gains importance in a broader context given the new Place of Effective Management (PoEM) criteria for determining the residential status of a company.

### Background

- The taxpayers are company incorporated under the Registration of Companies (Sikkim) Act, 1961. During the relevant assessment years ('AY') 1987-88 to 1989-90, the taxpayers claimed to have earned income by way of commission from sale of cardamom and agricultural products in the State of Sikkim.
- Sikkim was annexed into India with effect from April 26, 1975. The Constitution (Thirty Sixth Amendment) Act, 1975 inserted Article 371-F, in terms of which not all the laws of India were extended to

<sup>1</sup> *M/s Mansarovar Commercial Pvt Ltd. v CIT* [2023] Civil Appeal No. 5770-5773 of 2022



the new State of Sikkim. The Income-tax Act 1961 ('Act') was made applicable to Sikkim with effect from Assessment Year ('AY') 1990-91. Until AY 1989-90, tax was levied in Sikkim as per Sikkim State Income-tax Manual 1948 ('Sikkim Manual').

- For the relevant AYs, the taxpayers filed return under the relevant provisions of Sikkim Manual.
- In the course of survey proceedings conducted at the taxpayers' Chartered Accountant's ('CA') premises in Delhi, the Revenue found taxpayers' books of account, cheque books, signed blank cheques, vouchers and other income documents. Basis the said documents and statements recorded, the Assessing Officer ('AO') observed that the control and management of the taxpayers was wholly exercised by the CA based in Delhi. Since the taxpayers have place of control and management in taxable territory, the taxpayers would qualify as tax resident in India under section 6(3)(ii) of the Act<sup>2</sup> and the income was sought to be taxed in India.
- The AO in Delhi issued notice under section 148 of the Act for initiating reassessment proceedings. The taxpayers filed writ petition against the notice before the Sikkim High Court. The Sikkim High Court dismissed the petition stating lack of jurisdiction.
- The notice under section 148 was again challenged before the Delhi High Court, which directed the AO to complete the assessment subject to outcome of the writ petition.
- The reassessment proceedings were concluded against the taxpayer basis following fact findings:
  - All directors were from outside Sikkim (except one for which no proof of identity was provided);
  - All books of accounts and other documents (such as signed cheques, printed letter pads, etc.) were found at the premise of CA in Delhi;
  - Authorized signatories to the bank accounts of the taxpayers were based in Delhi;
  - No board meetings were conducted in Sikkim;
  - Genuineness of parties from whom the commission income was earned could not be proved;
  - Amount of commission disclosed by the taxpayer from cardamom was more than what could have been produced by Sikkim as a whole state;
  - There were no employees and no expenses incurred in Sikkim;
  - There had been a fund transfer from Delhi into the bank accounts at Sikkim to claim exemption in Sikkim and then the money was remitted back to Delhi;
  - The whole apparatus got erased post extension of the Act to Sikkim with

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<sup>2</sup> A company is said to be resident in India in any previous year, if it is an Indian company or during that

year, the control and management of its affairs is situated wholly in India.



effect from 1 April 1990 and no commission income was earned thereafter.

- The AO concluded that the taxpayer was intentionally trying to take advantage of prevailing law in Sikkim by routing money through Sikkim and ploughing them back in taxable territory. The AO treated the taxpayer as tax resident of India having control and management in Delhi.
- Aggrieved by the order, an appeal was filed before the CIT(Appeal). Consequently, the Delhi High Court dismissed the writ petition, as the taxpayers sought alternate remedy before appellate authority under the Act.
- CIT(A) upheld the re-assessment order. On appeal to the Tribunal, the Tribunal held that the CA could not be treated as the principal officer under section 2(35) of the Act without due notice to this effect. The Tribunal, basis judicial precedents and without appreciating the facts, held the matter in favour of the taxpayer and deleted the assessment.
- The Revenue preferred an appeal before the High Court. The High Court decided the matter against the taxpayer and additionally observed that:
  - CA was not acting merely as a professional advisor;
  - CA's own employees were appointed as directors of the taxpayer;
  - Rate of commission was unrealistic and beyond human probabilities.
- Basis observations of facts of the case, the High Court held that the CA had a vital say in the control and management of affairs of taxpayers. The CA was held to be head and brain of the taxpayers and taxpayers were held to be resident of India under section 6(3)(ii) of the Act. Aggrieved by the High Court order, the taxpayers preferred an appeal before the Supreme Court.
- The Supreme Court was posed with the question whether basis the facts of the case, the taxpayers could be said to be resident in India under section 6(3)(ii) of the Act (as it stood prior to 1 April 2017).

### Contention of the Taxpayer

- The taxpayer companies having been assessed to tax under the Sikkim Manual, and having discharged taxes under the said law, cannot be subjected to tax once again by applying the 'head and brain' rule.
- It is well settled law that a taxing statute should not be interpreted in such a manner that its effect will be to cast a burden twice over for the payment of tax on the taxpayers unless the language of the statute is so compelling that the Court has no alternative than to accept it.
- The applicability of the Act was not extended to Sikkim for the relevant AY 1987-88 to 1989-90. Hence, no income of the taxpayers should be taxed under the Act.
- AO in Delhi has no jurisdiction over the taxpayers. A CA having mere custody of



documents could not said to be the head and brain of the taxpayer.

- The business was carried on and managed by a director from Sikkim. The commission income was received in bank account of Sikkim.
- The CA cannot be regarded as 'Principal Officer' in absence of a notice issued to this effect.

### Contention of the Revenue

- Holding lands, receipt of payments and carrying on trade is of no consequence, as long as the control of the commercial venture and directions governing the commercial venture are given from elsewhere. Domicile or registration of the company is not relevant.
- The determinative test is, where the head and seat and directing power of the affairs of the company is, which works with some degree of permanence. The expression 'wholly' seems to recognize the possibility of the seat of such power being divided between two distinct and separate places.
- The facts of the case reveal that the control and management of the taxpayers was in Delhi and that it was a clear design to treat the income as arising from Sikkim to avoid the payment of tax under the Act. The control and management of the companies was being carried out by CA from his Delhi office. Therefore, the taxpayers should be treated resident in India and therefore liable to pay tax under the Act.

### Ruling of the Supreme Court

- The 'Control and management' is not merely theoretical control and power, i.e. not de jure control and power, but de facto control and power actually exercised in the course of the conduct and management of the affairs of the taxpayers.
- The domicile or the registration of the company is not at all relevant and the determinate test is where the sole right to manage and control of the company lies.
- In absence of any material on record that the commission was earned only in Sikkim, the taxpayers cannot be permitted to say that they were liable to pay the tax under the Sikkim Manual, and not under the Act.
- The taxpayers with mala fide intention and to evade the payment of tax under the Act came out with a case that they earned the income in Sikkim, which has not been established.
- Honourable Supreme Court concurred with the contentions of Revenue and upheld the High Court order treating the taxpayers as tax resident of India.

### Dhruva Comments

- Prior to amendment to section 6(3)(ii) vide Finance Act 2016 (i.e., insertion of concept of Place of Effective Management – 'PoEM' criteria), the Act had the concept of control and management for the purpose of determining residential status of a company.



- While interpreting the expression 'Control and management' under the Act, the Supreme Court followed various judicial precedents<sup>3</sup> and held that de facto control (i.e. the actual and not theoretical control) is necessary for determination of control and management under the Act.
- The test of 'Control and Management' involves a mixed question of fact and law. The result would depend upon the legal effect of the facts proved in the case.
- The Supreme Court order shall provide useful guidance in respect of the matters prior to AY 2017-18 wherein residential status of the company is under dispute.
- Post 1 April 2017, the provisions for determination of residential status of company have undergone change. A company having place of PoEM in India, shall be tax resident of India.
- PoEM guidelines<sup>4</sup> lay down objective criteria for determination of residential status of companies having active business outside India. For companies not having active business outside India, the principles of 'Control and management' can be referred to identify person and place of key management and commercial decision. The observations of the Supreme Court with regard to de facto control will be relevant even under the new PoEM requirements.
- The observations of the Supreme Court shall be relevant for determination of residential status of Hindu Undivided Family, partnership firm, association or

person and any person (other than individual and company) which are based on the 'control and management' test.

**Contributors:**

[Maharshi Mehta \(Principal\)](#)

[Sakshi Dolani \(Senior Associate\)](#)

Hope you will find this alert useful. For any queries in relation to this tax alert, you can reach out to Dhruva Advisors LLP.

<sup>3</sup> V.V.R.N.M. Subbayya Chettiar v. CIT, Madras, AIR 1951 SC 101; Erin Estate v. CIT, 1959 SCR 573; Narottan and Pereira Ltd. v. CIT 1953 23 ITR 454; B.R. Naik v.

Commissioner of Income Tax, Bombay, (1945) 13 ITR 124, etc

<sup>4</sup> Circular no. 6 of 2017 dated 24 January 2017





## ADDRESSES

### Mumbai

1101, One World Center, 11th floor,  
Tower 2B, 841 Senapati Bapat Marg,  
Elphinstone Road (West),  
Mumbai 400 013  
Tel: +91 22 6108 1000 / 1900

### Ahmedabad

B3, 3rd Floor, Safal Profitaire,  
Near Auda Garden,  
Prahlanagar, Corporate Road,  
Ahmedabad 380015  
Tel: +91-79-6134 3434

### Bengaluru

Prestige Terraces, 2nd Floor  
Union Street, Infantry Road,  
Bengaluru 560001  
Tel: +91-80-4660 2500

### Delhi / NCR

101 & 102, 1st Floor, Tower 4B  
DLF Corporate Park  
M G Road, Gurgaon  
Haryana 122002  
Tel: +91-124-668 7000

### Pune

305, Pride Gateway, Near D-Mart, Baner,  
Pune 411 045  
Tel: +91-20-6730 1000

### Kolkata

4th Floor, Unit No 403, Camac Square,  
24 Camac Street, Kolkata  
West Bengal 700016  
Tel: +91-33-66371000

### Singapore

Dhruva Advisors (Singapore) Pte. Ltd.  
20 Collyer Quay, #11-05  
Singapore 049319  
Tel: +65 9105 3645

### Dubai

WTS Dhruva Consultants  
Emaar Square Building 4, 2nd Floor,  
Office 207, Downtown,  
P.O. Box 127165  
Dubai, UAE  
Tel: +971 4 240 8477

## KEY CONTACTS

### Dinesh Kanabar

Chief Executive Officer  
dinesh.kanabar@dhruvaadvisors.com

### Punit Shah (Mumbai)

punit.shah@dhruvaadvisors.com

### Mehul Bheda (Ahmedabad)

mehul.bheda@dhruvaadvisors.com

### Sandeep Bhalla (Bengaluru)

sandeep.bhalla@dhruvaadvisors.com

### Vaibhav Gupta (Delhi/NCR)

vaibhav.gupta@dhruvaadvisors.com

### K. Venkatachalam (Pune)

k.venkatachalam@dhruvaadvisors.com

### Aditya Hans (Kolkata)

aditya.hans@dhruvaadvisors.com

### Mahip Gupta (Singapore)

mahip.gupta@dhruvaadvisors.com

### Nimish Goel (Dubai)

nimish.goel@dhruvaadvisors.com

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