Supreme Court rules on what constitutes management and control under Indian tax law

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In a recent ruling, India's Supreme Court ("**SC**") has held that the term "management and control" of a company means where the head, seat and the directing power of the business affairs lie. It is not merely theoretical or *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 company. Further, the domicile or the corporate registration of the company is not relevant, and the determinate test is where the sole right to manage and control the company lies. Even acting under a power of attorney is not sufficient as the power exercised by the holder is not *de facto* control.

While the SC ruling is in the context of domestic Indian tax law, it will serve as an encouraging stimulus to the Indian tax authorities who have increasingly applied a substance over form approach in examining Indian cross-border transactions that have intermediate holding structures.

Background

Five companies namely, Mansarovar Commercial Private Limited, Sovereign Commercial Private Limited, Swastik Commercial Private Limited, Trishul Commercial Private Limited and Pasupati Nath Commercial Private Limited (the "**Taxpayers**") were incorporated in the state of Sikkim under the Registration of Companies (Sikkim) Act, 1961. The Taxpayers were engaged in the business of trading in cardamon and other agricultural products, and the income generated was offered to tax in the state of Sikkim.

The state of Sikkim became a part of India in April 1975; however, the Income-tax Act, 1961 (the "**IT Act**") was not made applicable to the state of Sikkim until April 1, 1990. Until such time the Sikkim State Income-tax Manual, 1948, was being followed. The Taxpayers stated that each of them was a tax resident of Sikkim and carried on business activities in Sikkim until March 31, 1990, and, therefore, they were governed only by the Sikkim State Income-tax Manual, 1948 and not the IT Act. On the other hand, the Indian tax authorities (the "**ITA**") argued that the control and management of each of the Taxpayers was wholly with their chartered accountant ("**CA**") who was also their statutory auditor based in New Delhi. Thus, all the Taxpayers were resident in India in terms of Section 6(3) of the IT Act. Section 6(3) of the IT Act states that a company is said to be a resident in India in any previous year, if: (i) it is an Indian company; or (ii) its place of effective management, in that year, is in India. Further, "place of effective management" means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance, made.

The matter was litigated before the appellate Commissioner, the Income-tax Appellate Tribunal and the High Court, until it finally reached the SC.

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Key facts recorded in the SC judgment

- The Taxpayers' directors are all from outside Sikkim and have never been to Sikkim, and the lone director who was projected as a resident of Gangtok, Sikkim, could not prove that he was a resident of Sikkim.

- The entire books of accounts were found and seized in New Delhi at the address of the CA in New Delhi. Corporate tax returns were filed without audit reports. Auditors did not sign the profit and loss account or the balance sheets. No operating expenses like employee salaries, rent, or professional or legal fees were reflecting in the financial statements.

- Though bank accounts were available both, in New Delhi and Sikkim, the authorized signatories operating the accounts were based in New Delhi. The statutory books, corporate registers, shareholder details, company letter pads, blank company cheques, pass books and rubber stamps of the Taxpayers were all in New Delhi in the CA's possession.

- No evidence was produced for having conducted any board meetings in Sikkim. Moreover, the CA was not just doing audit work but also deciding on the appointment of directors.

The SC's ruling

Based on the above stated facts, the SC ruled that the domicile or the corporate registration of the company is not relevant, and the determinate test is where the sole right to manage and control of the company lies. The SC took a view that the Taxpayers had a *mala fide* intention to evade the tax under the IT Act and made a case that they earned their income within Sikkim, which was not established and proved.

Our comments

While the SC ruling is in the context of Indian domestic tax law, it will serve as an encouraging stimulus to the ITA. The ITA have increasingly applied a substance over form approach in examining offshore structures. A classical "substance analysis" involves the determination of an entity's place of effective management, i.e., the place where key management and commercial decisions necessary for the conduct of the business of the entity as a whole are, in substance, made.

In our view, offshore intermediate holding companies (based in Mauritius, Singapore, Cyprus or The Netherlands) will be expected to satisfy several parameters in order to establish "effective" residence and management in their countries of residence if they seek benefits under an applicable tax treaty. In a nutshell, offshore entities will be required to: (i) identify the persons who actually take key management and commercial decisions for the conduct of

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their business as a whole; (ii) establish that these persons, in fact, constitute their key managerial personnel (and not shareholders or delegated decision makers); and (ii) illustrate that these decisions have, in fact, taken in the state of residence.

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