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# Sikkim: Unveiling India's Secret Tax Paradise

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## ABSTRACT

*This article analyses the unique tax structure of Sikkim, a state in north-eastern India, and the attempts by the government of India to prevent fraud and misuse of its special tax status. The article outlines the history of Sikkim – including its accession to the Indian Union in 1975 – and its economy, as it is the first organic state of India and a major producer of cardamom. It then narrows in on Sikkimese tax law – specifically, the Sikkim Income Tax Manual of 1948 – and its unique nature, which grants certain tax exemptions to Sikkimese residents leading to instances of tax avoidance schemes and case-law decisions relating to them. The article delves into the misuse of certain provisions of Sikkim's tax laws, including schemes of tax evasion using shell companies, as evidenced by the 1980 Gift Scam. It then discusses the legal and regulatory responses of the Indian government to such cases, which include amendments to the Income Tax Act and the use of enforcement agencies such as the Serious Fraud Investigation Office. In conclusion, the article suggests certain steps to prevent the misuse of Sikkim's special tax status while upholding its special status. It emphatically opines that the different institutions of the Indian government, particularly the executive, legislature and the judiciary, must co-operate on this task.*

**Keywords:** Sikkim, Tax Haven, Sikkim Income Tax Manual, Organic State, Tax Evasion, India.

## I. INTRODUCTION

Sikkim (A paradise in the foothills of the Himalayas): Sikkim as a state is situated in the northeastern region of the Republic of India bordering Bhutan on its eastern flank, Tibet on its northern borders, Nepal on its western flank, and West Bengal neighboring its southern borders.<sup>3</sup> Sikkim stands atop the Siliguri corridor of India (India's chicken's neck) in its south which in turn borders Bangladesh. Sikkim holds the distinction of being the second smallest state in India after Goa and being the least populous of all the states.<sup>4</sup>

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<sup>3</sup> Karan Singh and Dr. Vivek Agrawal, "Tax evasion & black money generation in India: A conceptual analysis with reference to income tax law", 10 *IJARD* 263 (2023).

<sup>4</sup> Aarav Singh, "Sikkim – A Tax Haven in India", 5 *DLR* 112 (2022).

## II. HISTORY

The Lepchas are the earliest inhabitants of Sikkim. Phuntsog Namgyal established the kingdom of Sikkim in 1642 and became the first Chogyal (Buddhist priest-king). In 1853 British India annexed the districts of Darjeeling and Morang from the kingdom of Sikkim. Late in 1890, the Sikkim British Indian Empire gave a protectorate status to vibrant Sikkim and later a convention with China. After Indian independence, the protectorate status of Sikkim continued with the Republic of India in 1950. Under Chogyal Palden Thondup Namgyal Sikkim achieved the best-ever literacy rate and a whopping per capita income of almost twice that of Nepal, Bhutan, and India, the Sikkim National Congress dissatisfied with the unimportant representation of Nepali in administration continued demanding a fresh election. Anti-royalist riots broke out in 1973 in front of the palace of the Chogyals. Following the request of the then prime minister of Sikkim Kazi Lhendup Dorjee the Indian army captured Gangtok in 1975 following which a referendum was held a dismal 2.5 % of the voters supported monarchy thus approving the merger with India. Sikkim became the 22<sup>nd</sup> state of the Republic of India on 16<sup>th</sup> May 1975 abolishing the monarchy. The Indian parliament passed the 35<sup>th</sup> and the 36<sup>th</sup> amendments to the Indian constitution to make Sikkim first an associate state and then a full-fledged Indian state incorporating its name into the first schedule of the Indian constitution.<sup>5</sup>

The Chinese government recognized Sikkim as a part of India only in 2003 following a treaty with its Indian counterparts accepting Chinese sovereignty over Tibet. Following the 2003 agreement Sino-Indian relations finally saw a thaw which led to the opening of the Himalayan pass of Nathu La for cross-border trade on 6<sup>th</sup> July 2006, which had been closed since the Sino-Indian War of 1962.

## III. ECONOMY

IN 2019 Sikkim's nominal GSDP stood at 4.6 billion US dollars with a per capita income of around 7530 dollars which amounts to 5,50,000 rupees which places Sikkim to be the 3<sup>rd</sup> smallest state in terms of GDP in India. Sikkim has a predominantly agrarian economy producing crops such as rice, wheat, tea, maize, barley, orange, cardamom, and millet. Sikkim holds the distinction of being the largest cardamom cultivator in India.

The southern regions of Sikkim house many of its major industries which include mainly brewing, distilling, tanning, and watchmaking. The towns of Melli and Jorethang are the major industrial hubs of the state of Sikkim, with a compact mining industry of copper, talc, coal, zinc,

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<sup>5</sup> Rajesh Kumar, "The Economic Impact of Tax Havens: Sikkim's Case Study", 5 *DLR* 134 (2022).

lead, graphite, and dolomite. Sikkim is one of the fastest-growing economies among Indian states.<sup>6</sup>

In 2015, Sikkim achieved a remarkable feat of becoming India's first organic state achieving its target of converting completely to organic farming that it set for itself in the year 2003.<sup>7</sup>

#### **(A) Taxation laws of Sikkim**

When Sikkim was merged into the Indian Union there was a condition that all the prevailing laws of Sikkim be kept intact thus the Indian parliament inserted Article 371 (f) into the Indian constitution. This meant that the residents of Sikkim were governed under the Sikkim Income Tax Manual 1948 instead of the Income Tax Act 1961.

Under this law, the residents of Sikkim were not supposed to pay any kind of income tax to the central government with the exact wordings of the clause as: -<sup>8</sup>

*“Any income, which accrues or arises to a Sikkimese individual from any source in the State of Sikkim or by way of dividend or interest on securities, shall not be included in the total income of such individual.”<sup>9</sup>*

#### **(B) Exemptions under Sikkim Income Tax Manual 1948**

A Sikkimese resident is not required to obtain a PAN card or to file an income tax return to the Indian government.

1. No exemption from taxation to a Sikkimese woman who marries a non-Sikkimese male.
2. Exemptions apply only to those individuals whose names are recorded under the register of Sikkim.
3. Any company incorporated in Sikkim under the Registration of Companies (Sikkim) Act 1961 is exempt from income tax under the provisions of the Income Tax Act 1961

However, it is important to note that the above-mentioned second exemption was struck down by the Supreme Court of India in the case of the *Association of Old Settlers of Sikkim and Ors. versus Union of India and Anr. ...Appellant(s)*<sup>10</sup> as unconstitutional on grounds of articles 14, 15, and 21 of the Indian constitution.

Under the Finance Act 2023, the Indian government amended section 10(26AAA) to provide a

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<sup>6</sup> M. Govindarao, "Tyranny of the Status Quo: The Challenges of Reforming the Indian Tax System", 48 *IPF* (2015-16).

<sup>7</sup> Ankur Patel, "Sikkim's Tax Haven Status: Implications for Indian Federalism and Taxation Policy", 5 *DLR* 158 (2022).

<sup>8</sup> Priya Desai, "Taxation Policies in Sikkim: A Comparative Analysis", 5 *DLR* 120 (2022).

<sup>9</sup> Sikkim Income Tax Manual, 1948

<sup>10</sup> 2023, SCC ONLINE SC 1348

revised definition of Sikkimese as “any Indian who permanently settled in Sikkim before its merger with India on April 26, 1975, even if they were not included in the Sikkim subject’s regulation register.”<sup>11</sup>

#### **IV. GIFT SCAM 1980**

In 1980 a scam broke out in Sikkim in which numerous individuals, industrialists and businessman from all over India, laundered their black money by handing it over to the Sikkimese residents asking them to send 85 % of the amount back to the former as gifts instead of rest 15% as commission. The scammers exploited the loopholes provided under the Sikkim income tax manual 1948 wherein the residents were exempted from providing a PAN no. to open a Demat account.<sup>12</sup>

After the scam came to light the central government made efforts to bring Sikkim under the purview of the Income Tax Act 1961 but in vain. In 2008 section 10 (26AAA) was inserted in the Income Tax Act 1961 giving legitimacy to the already prevailing exemptions. This meant that any income that was generated within the boundaries of Sikkim by any Sikkimese resident could not be taxed by the central government and would be governed only by the state laws of Sikkim. This distinction was upheld by the Supreme Court in 2023 thus allowing the exemptions to continue for all the citizens of India who settled in Sikkim before its merger with India.

The registration of companies (Sikkim) 1961 allows exemption to the companies registered in Sikkim from any form of corporate taxes which can become a potential source of tax evasion scams which can be understood by the aforesaid examples: -

1. The laws governing the financial autonomy of Sikkim may allow a commodity, futures or any other trading platform to grow multiple times within a short span of 1 to 5 years without paying any corporate tax to the central government thus causing unfair competition with other similar players around the nation outside Sikkim.
2. A big company dealing in processed food products ranging from juices to cookies establishes its head office in Sikkim without any effective operations or management in Sikkim with almost whole of its production, sale, and marketing activities taking place in states of Uttarakhand, Jammu and Kashmir Himachal Pradesh and Haryana through its subsidiaries may engage in base erosion activities to transfer almost all of its taxable

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<sup>11</sup> Meena Chaudhary, "Legal Framework of Tax Havens: Understanding Sikkim's Unique Position in India", *5 DLR* 145 (2022).

<sup>12</sup> No income tax: Why residents of THIS Indian state exempted from paying taxes?, available at: <https://www.livemint.com/news/india/no-income-tax-why-residents-of-this-indian-state-sikkim-exempted-from-paying-taxes-11676505925327.html> (visited on April 7, 2024).

income to the head office in Sikkim in way of interest payments and royalties, dividend and avoid a major chunk of tax revenue to the central government in way of lost corporate taxes.

3. The State Bank of Sikkim abbreviation (SBS) does not come under the ambit of RBI thus allowing the residents to deposit any amount of money in their bank accounts without the need for mandatory KYC (Know your customer) requirements which holds the immense potential of large-scale tax evasion which can be understood with the following examples:
4. In 2016 during the period of demonetization RBI witnessed a surge in the deposits at SBS and tried to block 52000 accounts due to fear of them being used to hide black money. But to RBI's surprise the than home minister of India came out in support of SBS publicly and highlighted the provisions mentioned under article 371 F of the Indian constitution. Following this debacle, the government of Sikkim issued an advisory for the Sikkimese residents asking them not to allow non-Sikkimese to use their bank accounts to deposit money as the same falls within the purview of tax evasion activities thus terming such actions as illegal.<sup>13</sup>

## V. RECENT INCIDENTS

In the recent past, the government of India has taken many steps ranging from legislative procedures and executive actions to judicial cases to deal with the menace of tax evasion activities taking place by individuals by unfairly and illegally using the tax laws prevailing in Sikkim.

Some of the recent examples of such proactive steps by the Indian government are as follows:

1. The Indian government enacted the Sikkim (Collection of Taxes and Prevention of Evasion of Payment of Taxes) Act, 1987 to deal with the problem of shell companies being created in Sikkim to avoid taxation .it dealt with attempts to recover taxes and to prevent the widespread formation of shell companies with silent Sikkimese promoters. This act was upheld by the Delhi High Court in the case of *Commissioner of Income Tax -Delhi v. Mansarovar Commercial Pvt Ltd and Ors*<sup>14</sup>. In which the operations of the company were found to be managed by a team of chartered accountants based in Delhi instead of Sikkim thus proving beyond the doubt that the laws in Sikkim were

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<sup>13</sup> Palak Shah, "Tax-free Sikkim, A Haven for Commodity Market Speculators" *The Hindi business line* April 04, 2022.

<sup>14</sup>(20.07.1993 - SIHC)

being used for money laundering to avoid taxation in India.

2. In 2022 the commodities market in Sikkim suddenly grew exponentially since the provisions of Stamp Act 1899 do not apply to corporations based in Sikkim. Here it is important to understand that stamp duty is a tax levied while issuing, selling, and transferring instruments like stocks debentures currency derivatives, and commodity instruments. This act was extended to the whole of India in 2019 except Sikkim which made it a favourable destination for traders. The favourable conditions that attracted the traders were namely lax PAN requirements and taxation rules which made Sikkim a tax haven.
3. **In Himal Enterprise Pvt ltd v. income tax officer<sup>15</sup>**, ward -Gangtok Sikkim, the income tax appellate tribunal Kolkata gave in its verdict that the above-mentioned entities be taxed as an association of persons.

Both of the above-mentioned examples clearly show how differential tax structures in the same country can lead to the formation of a tax haven within the country causing significant loss of crucial tax revenue to the government and an uneven playing field for various players in the same market. It is also tantamount to a violation of several international agreements at WTO, bilateral investment treaties, financial action task force, etc

## VI. CONCLUSION

With the enactment of the Companies Act 2013 the (Registration of Companies) act,1961 has been finally repealed only in name as all its benefits remain applicable as the Companies definition under the Companies Act 2013 still does not cover any entity incorporated in Sikkim either before or after the enactment of the companies act 2013 thus it actively leaving them out of the purview of corporate tax rules of India.

In recent times the authorities have taken proactive measures such as employing the place of effective management (POEM) test in determining the actual place of income generation to determine whether it was generated within Sikkim or outside it and to ascertain whether the income generators are Sikkimese residents or not.

Concerns raised by executive authorities in the past: -

1. Ex-RBI governor - *“We were persuading the government to bring it under Reserve Bank’s purview, but these arrangements are all relating to diplomatic terms and we (the*

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<sup>15</sup> ITA No. 103/Kol/2018.

*regulator) are not privy to that,*<sup>16</sup>

2. Ex-deputy RBI governor: he compared the SBS to the Swiss bank in terms of secrecy and their weak and lax KYC norms which allows a huge benefit for tax fraudsters all owing to the complete lack of proper regulations.
3. Comptroller and Auditor General of India: raised concerns over the SBS's noncompliance with banking regulations coupled with numerous violations during the period of demonetization and shed light on how all the above facilitated withdrawal of huge amounts over and above the prescribed limits.

#### **(A) Suggestions**

1. To help identify those individuals and business entities that engage in illegal activities like asset hiding and to find out underreported income the govt authorities need to do rigorous inspection of any large cash flows from the bank accounts of Sikkimese residents to the bank accounts of other Indian nationals.
2. To find out any possible tax evasion it becomes extremely crucial to verify all the Sikkim-based traders and their trading activities so that the laws in place aren't misused.
3. To establish a cooperation mechanism between RBI, SBS, and the central as well as state govt to identify any potential case of tax evasion and find countermeasures.

To maintain the integrity of the tax system it is of utmost importance that all the relevant parties cooperate and ensure that everyone pays their fair share to the tax authorities under the prevailing laws.

Thus, it becomes extremely necessary for the executive, legislature and judiciary of the Republic of India to act in synergy and fill all the loopholes in the current tax laws without undermining the legitimate rights of the Sikkimese residents as both the rights and the laws go hand in hand for the prosperity of the nation.

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<sup>16</sup> (18.08.2000 - SIHC)