

Finance Bill 2015's POEM-Does it Rhyme Well?



It is proposed to amend Section 6(3) of the Act to provide that a company incorporated outside India, shall be said to be resident in India in any previous year if its place of effective management, at any time during the year, is in India. Further, the explanation to Section 6(3) proposes to define the 'place of effective management' as a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. The Memorandum states that though POEM is a fact dependent exercise, the guiding principles for determination of POEM for the benefit of the taxpayers as well as Revenue shall be issued in due course of time. The proposed amendment is to be made applicable immediately with effect from financial year 2015-16. Read on to know more....

I. Tax Residency of a Company-Current and Proposed Provisions

The residence of an entity has always remained the basis on which its tax incidence can be determined. The residential status of a company, being a person having a separate legal juristic entity, shall have a residential status distinct from its shareholders.

As per the existing provisions of Section 6(3) of the Income-tax Act, 1961 (referred to as 'the Act') a company shall be considered as resident in India in any previous year if:

- i. it is an Indian Company; or
- ii. during that year, the **control and**

management of its affair is **situated wholly in India.**

While introducing certain amendments to the above provisions, the Memorandum to Finance Bill 2015, explaining the provisions of Section 6(3) states as under:

- Due to the requirement of control and management being situated in India and that too for the whole of the year, the condition has been rendered to be practically inapplicable.
- A company can easily avoid becoming resident of India by simply holding a board meeting outside India which facilitates creation of shell companies which are incorporated outside but controlled and managed from India.
- Place of effective management (POEM) is a recognised concept for determination of residence of a company incorporated in foreign jurisdiction.



CA. Sanjiv Chaudhary

(The author is a member of the Institute. He can be reached at casanjivchaudhary@gmail.com.)

- The proposed amendment would align the provisions of the Act with the Double Taxation Avoidance Agreements (DTAA) entered into with other countries as well as the international standards.

In view of above, it is proposed to amend Section 6(3) of the Act to provide that a company incorporated outside India, shall be said to be resident in India in any previous year if its **place of effective management, at any time during the year, is in India**. Further, the explanation to Section 6(3) proposes to define the 'place of effective management' as a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made.

The Memorandum states that though POEM is a fact dependent exercise, the guiding principles for determination of POEM for the benefit of the taxpayers as well as Revenue shall be issued in due course of time. The proposed amendment is to be made applicable immediately with effect from financial year 2015-16.

II. The Saga of progressing/evolving Tie-breaker rule

Globally, the basis for determination of residential status of a company may vary depending upon the domestic tax laws of different countries. A number of conventions for avoidance of double taxation confer the taxing rights to the state in which the place of effective management is situated, other conventions attach importance to place of effective management and others again to fiscal domicile of the operator. In such a situation, where the company is classified as a tax resident of both the contracting states, the tie breaker rule specified in the DTAA between both the countries would be relevant for determining the country of residence.

- A. It would be interesting to note as to how the Model Convention has transformed over the years on the aspect of dual residency of corporations. Originally, when the tie breaker rule was included in the Draft Convention, the Organisation for Economic Co-operation and Development (hereafter referred to as 'OECD') Fiscal Committee expressed the view that "it may be rare in practice for a company, *etc.* to be

subject to tax as a resident in more than one state"¹ but because that was possible, 'special rules as to the preference must be established'.

Subsequently, an alternative version of Article 4(3) was introduced in the OECD Model Tax Convention-2008, according to which the competent authorities of the Contracting states shall, having regard to a number of relevant factors, endeavour to determine by mutual agreement the state of which the person is a resident (Paragraphs 24 and 24.1 of the Commentary on Article 4 may be referred for complete text). The relevant factors illustrated under the Model Convention to be considered by the Competent Authorities, while determining the residence of a company are:

- Where the meetings of its board of directors or equivalent body are usually held;
- Where the chief executive officer and other senior executives usually carry on their activities;
- Where the senior day-to-day management of the person is carried on;
- Where the person's headquarters are located;
- Which country's laws govern the legal status of the person;
- Where its accounting records are kept;
- Whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc.

It may be relevant to note that the Convention does not restrict the reference to such factors, the competent authorities may also refer to other factors additionally, that they consider relevant for determining POEM.


It can be comprehended that POEM is the generally accepted principle and assumes a vital role in determining the residential status of the companies incorporated in foreign jurisdiction. Place of Effective Management- locating the international contours


¹ Paragraph 23 of the Commentary on Article 4 of the 1963 Draft Convention.

Union Budget 2015-16

— —

The existing provisions of the Act determining the residential status of a company states a company can be said to be a resident in India if during that year, control and management of its affairs is situated wholly in India. Therefore in case of a foreign company, even if slightest control and management is exercised from outside India, it would not fall within the ambit of Section 6(3)(ii) of the Act and the company would be treated as non-resident.

— —

B. The UN Model Commentary on Article 4(3) states that the circumstances which may, inter alia, be taken into account while establishing POEM are:

- the place where a company is actually managed and controlled;
- the place where the decision making at the highest level on the important policies essential for the management of the company takes place;
- the place that plays a leading part in the management of a company from an economic and functional point of view;
- the place where the most important accounting books are kept.

On one hand, the OECD commentary of 2008 specifically removes the reference to the board of directors and reiterates the emphasis on the place where the decisions are made in substance. The UN Model on the other hand lays emphasis on the place where company is actually managed and controlled.

C. The views expressed by Prof. Klaus Vogel in the Commentary on International taxation, with regard to determination of the place of effective management are noteworthy. The following factors have been considered as relevant for determining the place of effective management:

- What is decisive is not the place where the management directives take effect but rather the place from where they are given.
- The centre of management activities of a company generally is the place at which the authorised personnel carries on his business managing activities.

- A place from where business is merely supervised would not qualify.
- If the commercial and non-commercial side of the business are managed from different places, the place of commercial management will be controlling.
- Subsequently, if the place of effective management cannot be determined based on above criteria, the top manager's residence will regularly determine the residence of the company.
- Article 4(3) is designed to make possible a clear determination of residence, only one place is acceptable as the centre of top level management.

On the basis of the above, it can be comprehended that POEM is the generally accepted principle and assumes a vital role in determining the residential status of the companies incorporated in foreign jurisdiction. **Place of Effective Management-locating the international contours**

The possibility of a company being treated as a tax resident of more than one state cannot be averred, for example some states emphasise the place of incorporation or situation of head office as the basis of determining residence, other states determine the residence based on the place of effective management. The divergent principles adopted internationally for determining the tax residency of a person other than an individual is summarised as under:

- a) **Australia, Belgium, Brazil, Cyprus, Denmark, France, Germany etc.-** Resident of a state in which place of effective management is situated
- b) **Canada-** place of management or any other criterion of similar nature. However the tie breaker rule provides that competent authorities by way of mutual agreement shall settle the question and in absence of such agreement, such person shall not be deemed to be resident of any of the states for the purpose of enjoying treaty benefits.
- c) **China-** State where the Head Office is situated.

- d) **France-** In addition to POEM, place where person or group of person who exercise the most senior functions makes its decision. The place where the organs of direction, management and control of the entity are mainly located.
- e) **Hungary-** In addition to POEM, place where chief executive officer and other senior executives usually carry on their activities as well as the place where the senior day to day management of the enterprise is usually carried on.
- f) **Italy-** place where the main and the substantial activity of the entity is carried on is also to be taken into account while determining POEM.
- g) **Japan & Korea-** use 'head or main office' instead of POEM.
- h) **Turkey-** Right to use the 'registered office' criterion as well as POEM.
- i) **Argentina, Russia, Vietnam-** Practical day to day management, irrespective of place of control.
- j) **United Kingdom-** incorporated or centrally managed and controlled instead of POEM.

It is clearly evident from the divergent principles adopted globally by various countries that the manner in which they chose to select the jurisdiction for tax under the domestic laws may differ. However, there is certainly a degree of consensus on the basic principle that there should be a fairly strong economic nexus with the country which reserves the right to tax. There is no objective test to determine the tax residence of such person and all relevant facts and circumstances of the case must be examined holistically to determine the POEM of the entity.

The OECD Commentary provides that the place of effective management is where key management and commercial decisions necessary for the conduct of the entity's business are in substance made. The Commentary further explains that place of effective management will ordinarily be where the most senior person or group of persons make decisions; the place where the actions to be taken by the entity as a whole are determined. A careful reading indicates that the Commentary has chosen not to use the term Board of Directors, rather provides a wider term 'group of persons' that

may include Board but not necessarily confine to the Board.

The OECD model observes that while an entity can have more than one place of management, but it can have only one place of effective management at any one point of time. The Memorandum evidently recognises that POEM is an internationally well accepted concept and there are well recognised guiding principles for determination of POEM, although it is a fact dependent exercise.

III. POEM & BEPS

Addressing the issue of treaty abuse has been a prime focus area for OECD. The Base Erosion and Profit Shifting (BEPS) Action Plan 6 endeavours to curb the multi layered structures enticed by no or low tax jurisdictions through preventing the granting of treaty benefits in inappropriate circumstances. The Public Discussion Draft on BEPS Action 6 released by the OECD, specifically deals with tie-breaker rule for determining the treaty residence of dual resident persons amongst other situations, where a person seeks to circumvent treaty benefits.

The OECD Model as well as various tax treaties recognise POEM as a tie breaker rule in case of dual residency. The existing rule which relies on the POEM concept is proposed to be replaced with Competent Authority determination. The proposed amendment provides that the competent authorities of the contracting states, having regard to the relevant factors, endeavour to determine by mutual agreement the state of which the person is a resident.

The role of a Competent Authority has been broadened by empowering them with discretionary authority to resolve disputes on treaty entitlement. The Competent Authority is likely to be inclined towards applying domestic

— [REDACTED] —

One hopes that the Government will take note of the above concerns surrounding this amendment and at the same time ensure that appropriate changes are made before the Bill is passed. The Government, as stated in the Memorandum to the Bill, should lay down clear guidelines for determination of POEM for the benefits of the taxpayer as well as tax administration.

— [REDACTED] —

Union Budget 2015-16

guidance and judicial precedence while arriving at any conclusion on determination of the residential status of companies.

It would be pivotal to note at this stage that, in 2014, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax avoidance cases involving dual resident companies. It, therefore, concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with situations on a case-by-case basis.

While, OECD plans to address the issues of dual residency in BEPS Action Plan 6 in a more liberalised manner, the proposed amendments if made effective as is without careful calibration would result in protracted litigation. Moreover, this would be deviation from the international standards which is completely distinct from the reasons set out in the Memorandum.

IV. Proposed Amendment overruling Existing Judicial Pronouncements

The existing provisions of the Act determining the residential status of a company states a company can be said to be a resident in India if during that year, control and management of its affairs is situated wholly in India. Therefore in case of a foreign company, even if slightest control and management is exercised from outside India, it would not fall within the ambit of Section 6(3)(ii) of the Act and the company would be treated as non-resident.

The expression 'control and management' has been a subject matter of judicial interpretation in the past and had traversed through divergent views on the matter. On one hand it has been held that the place where the Board of Directors takes the decision is POEM. On the other hand it has also been held that POEM refers to place from where day to day affairs are managed and controlled. The legal position (until the proposed amendments) is now well-settled that the expression 'control and management' means control and management and not carrying on day to day business. Certain principles which emerge from judicial precedents in the context of POEM are summarised below:

- POEM is the place where key management decisions are actually taken
- The place where day-to-day affairs of the

It has been clearly stated in the Memorandum to Finance Bill as well as clarified in the post budget discussion that the intent behind the proposed amendment is primarily to focus on shell companies which are incorporated in foreign jurisdiction but are being managed and controlled from India. These companies would generally hold some meetings abroad to circumvent the Indian tax residency rules. The proposed law, however, goes beyond the stated intent.

company are carried on does not constitute POEM

- Factors such as company secretary, registered office may not be relevant for determining POEM
- POEM is not necessarily at a place where the employees are based
- The onus would be on the Tax department to prove that POEM lies at a place other than the place where board meetings are held.

The proposed amendment would nullify the impact of the decision in following cases:

- 1 Bombay High Court in the case of *Narottam & Pereira vs. CIT [1953] 23 ITR 454 (Bom)*, held that in case of a foreign company, it must be established that the de facto control and management of the affairs should be in India.
- 2 The Delhi Bench of ITAT in the case of *Radha Rani Holdings P. Ltd. vs. ADIT (2007) 16 SOT 495 (DELHI)*, held that even if a slightest control and management is exercised from outside India, it would not fall within ambit of Section 6(3)(ii) and company would be treated as a non-resident. Even a partial control of the company outside India is sufficient to hold the company as a non-resident. Moreover, in case of a company, the Department has to establish that control and management of its affairs is situated wholly in India, for the company to be treated as resident in India.

V. Comments on POEM

Since the determination of residential status of a company plays an important role in determining the scope of its total income chargeable to

tax in India, it would be contextual to look at some of the possible implications and issues arising therefrom on account of the proposed amendments. The Memorandum to the Bill recognises that POEM is a fact dependant exercise and acknowledges that POEM is an internationally well accepted concept and there are recognised guiding principles for determination of POEM. Few observations/comments on the proposed amendment are mentioned hereunder:

- The meaning of expressions 'key management and commercial decisions', decisions 'necessary for conduct of business' and 'entity as a whole' do not find place in the amendments. Being subjective, these expressions are subject to diverse interpretation and the proposed amendment can become cause of protracted litigation.
 - While the proposed amendment seeks to align the criterion for tax residency of the companies with international standards,
- the language of the proposed amendment is drafted such that in case of a company incorporated outside India, even if its POEM is in India only for a day or a part of the day during a financial year, it shall be deemed to be a tax resident of India. In such a scenario, the global income or part thereof may be exposed to be chargeable to tax in India. This issue needs immediate attention of the Legislature as the intention behind the proposed amendment is to take steps against shell companies incorporated outside India.
- The Memorandum states that the proposed amendments would align the provisions of the Act with the international standards. Contrastingly, there seems to be a departure from the international norms since neither the Conventions nor the Commentaries specify a specific time criteria for determining POEM, in contrast to the proposed amendment which specifies "any time during the year".

Union Budget 2015-16

- On one hand, the existing provision of Section 6(3) states that a company shall be deemed to be resident of India if the control and management of affairs is situated wholly in India. On the other hand, the proposed amendment emphasise that a company would become resident if the POEM is in India 'at any time during the year'. There is a complete shift in the thought process from 'control and management situated wholly in India' to 'place of effective management at any time in that year'. Is this complete shift really warranted, as it also becomes applicable to foreign companies practically having almost all control and management outside India (with some operations in India) which does not seem to be the intent of the Legislature as is evident from the budget documents?
- The condition specified in the explanation as to where the decisions as a whole are in substance made should be honoured and enough safeguards be made to ensure that companies incorporated in foreign jurisdiction are not dragged into this net where there is no real intention to manage the affairs from India. The amendment as provided in the section vis-a-vis the explanation seems to be not in consonance with each other since the 'decision as a whole in substance' cannot be seen isolated at any specific time during the year.
- The intention, as it appears from the budget documents, has been to target the offshore shell companies controlled and managed from India. However, the wide scope of interpretation of the amendment may possibly lead to unwarranted consequences for genuine companies including foreign companies with legitimate business operations outside India and having some decision making process happening across the globe.
- The hardship of outlining the domain of POEM in view of increased mobility and functional decentralisation as well as global sharing of resources is not bereft of challenges. The physical presence of a person is no longer necessary to run a business, in view of sophisticated telecommunication technology and fast and economical mode of communication.

One hopes that the Government will take note of the above concerns surrounding this amendment and at the same time ensure that appropriate changes are made before the Bill is passed. The Government, as stated in the Memorandum to the Bill, should lay down clear guidelines for determination of POEM for the benefits of the taxpayer as well as tax administration.

VI. Parting Thoughts

In view of the clear and unambiguous language of the provisions of Section 6 of the Act, it did not face many challenges. There has been no change in the provision since the time the provisions were introduced in the Act. The key takeaways from the article are indicated as under:

- Firstly, it has been clearly stated in the Memorandum to Finance Bill as well as clarified in the post budget discussion that the intent behind the proposed amendment is primarily to focus on shell companies which are incorporated in foreign jurisdiction but are being managed and controlled from India. These companies would generally hold some meetings abroad to circumvent the Indian tax residency rules. The proposed law, however, goes beyond the stated intent.
- Secondly, quite distinct to the intention (behind the proposed amendment) of aligning the provisions to international standards, it is expected that it would severely complicate the situation because of the 'any time in the year' condition attached to the POEM test. It has been clarified in the post budget discussion that the term 'any time during the year' in the context of this amendment should not be interpreted narrowly and CBDT would soon issue guidelines minimising the assessing officer's discretion. It will be a wait and watch situation until clearer guidelines are issued.

It is recommended that the proposed amendment in its current form be reconsidered and appropriate guidelines be issued to clear the existing apprehensions and bring in the much desired clarity with a view to mitigate the foreseeable protracted litigation. ■