

## Tuning in the POEM's Draft Guidelines



*The Finance Act, 2015 amended the provisions for the determination of residence of the companies to provide that a company would be regarded as resident in India, if it is an Indian company or the POEM of the company is in India during the relevant year. The Memorandum to the Finance Bill, 2015 stated that the CBDT would issue guiding principles for the determination of POEM. Accordingly, the government of India has now proposed new draft regulations that shall guide the process for such determination. This article attempts to familiarise the readers with the key guiding principles proposed in the Guidelines and also make them aware of its far reaching implications on all stakeholders. Read on...*

### I. Overview

The provisions of the Section 6(3) of the Income-tax Act, 1961 (the Act) prior to the amendment made by the Finance Act 2015, provided that a

company shall be treated as resident in India, in any previous year if, it is an Indian company; or during that year, the control and management of the company is wholly situated in India. The Finance Act, 2015, amended the provisions of Section 6(3) of the Act to provide that a company incorporated outside India, shall be said to be a resident in India,

(Contributed by the Committee on International Taxation of the ICAI. Comments may be sent to [citax@icai.in](mailto:citax@icai.in).)

in any previous year if, it is an Indian company or its *place of effective management (POEM)*, in that year, is in India. Further, the Explanation to Section 6(3) defines the POEM 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 to the Finance Bill, 2015 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 the Revenue shall be issued in due course of time. In view of the above, the Central Board of Direct Taxes (CBDT) has now issued draft guidelines ('the Guidelines') for determination of POEM and invited comments and suggestions from the stakeholders. The Guidelines foresee many challenges.

## II. Internationally Accepted Principles Determining POEM

Globally, the basis for determination of the residential status of a company may vary depending upon the domestic tax laws of different countries. While, primarily, POEM is taken as the basis for determining residence of companies; the fiscal domicile, the place where the registered office is situated, and numerous other factors are given equal importance. 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 Double Tax Avoidance Agreement (DTAA) between both the countries plays a pivotal role in determining the country of residence.

The relevant factors illustrated under the *Model Convention* to be considered by the competent authorities while determining the residence of a company are a) the place where meetings of its board of directors or equivalent body are usually held; b) the place where the chief executive officer and other senior executives usually carry on their activities; c) place where the senior day-to-day management of the company is carried on; d) the place where the company's headquarters are located or where its accounting records are kept. 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.

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The *UN Model Commentary* on Article 4(3) states that the circumstances which may, *inter alia*, be taken into account while establishing POEM are a) the place where a company is actually managed and controlled; b) the place where the decision making at the highest level on the important policies essential for the management of the company takes place; c) the place that plays a leading part in the management of a company from an economic and functional point of view; d) the place where the most important accounting books are kept.

It is clearly evident from the divergent principles adopted globally by various countries that the manner in which they choose to select the jurisdiction for tax under the domestic laws may differ. 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. 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.

## III. Draft POEM Guidelines- A Snapshot

The Guidelines propose to define certain expressions:

- **Passive income** is defined to be the aggregate of:
  - income from transactions where both purchase and sale of goods is from/to its associated enterprises; and
  - income by way of royalty, dividend, capital gains, interest or rental income.

# International Taxation

- A company shall be said to be engaged in **active business outside india (ABOI)** if:
  - passive income is not more than 50% of its total income;
  - less than 50% of its total assets are situated in India;
  - less than 50% of total number of employees are either situated in or resident of India; and
  - payroll expenses on such employees is less than 50% of its total payroll expenditure.
- **Head Office** of a company is the place where the company's senior management and their direct staff are located and in a case of multiple locations, the place where they are primarily or predominantly located.
- **Senior Management** is defined as persons generally responsible for developing and formulating key strategies and policies, and ensuring or overseeing the execution or implementation of those strategies on a regular basis.

The key guiding principles recommended in the Guidelines for determination of POEM are as under:

- POEM concept is one of the substance over form, and its determination will depend upon the facts and circumstances of the case.
- A company may have more than one place of management, but it can have only one place of effective management at any point of time. POEM is required to be determined on a year-to-year basis.
- The primary basis for determination of POEM shall be based on whether or not the company is engaged in active business outside India (ABOI) and in its determination, the average data of previous year and two years prior to that shall be taken into consideration. In case, the company is in existence for a shorter period, the data for such period shall be considered.
- POEM of a company engaged in ABOI shall be presumed to be outside India if the majority meetings of the board of directors are held outside India. However, in circumstances where the Board is not exercising its powers, or such powers are exercised by the holding company or any other person in India, the POEM shall be considered to be in India.
- In case of companies other than those engaged in ABOI, POEM shall be determined as follows:
  - Identification of persons responsible for making key management and commercial decisions for the conduct of company's business as a whole.
  - Determination of place where the decisions are taken. The place where decisions are taken would be more important than the place where the decisions are implemented.
- The place where the company's board regularly meets and makes decisions may be its POEM, provided, it retains and exercises its authority to govern and in substance makes the key management and commercial decisions for the conduct of company's business as a whole. A mere formal holding of meetings at a place would not be conclusive for determination of PE. However, if the board *de facto* delegates the authority to make key management and commercial decisions, the place where such persons make the decisions would be relevant for determination of POEM.
- The location of a company's head office is an important factor determining POEM. If the company's senior management and their support staff are located in a single location and the location is held out publicly to be the headquarters then that location is the place where the head office is located. However, if the company is decentralised, company's head office would be the location where the senior management a) are primarily based, b) normally return to after travel to other locations, or c) meet when formulating or deciding key strategies or policy.
- Routine operational decisions taken by the junior and middle-level management shall not be relevant for determining POEM.

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- Due to the use of modern technology, it may not be necessary for the persons taking decisions to be physically present at a particular location where the board meeting or meeting of senior management is held. Such places may not be the place where the key decisions are in substance made. In such cases, the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor for determination of POEM.
- If the aforesaid factors do not lead to a clear determination of POEM, then secondary factors viz. place where main and substantial activity of the company is carried out or place where accounting records are kept may be considered.

The Guidelines recommend that the principles stated therein for determining POEM are for guidance only, and none of the principles can be universally applied to all situations. It is even suggested that the principles are not to be seen with reference to a particular moment, rather have to be applied over a period of time. Further, it is also proposed that if the POEM of a company is determined to be in India as well as outside India, then POEM shall be presumed to be in India if it has been mainly or predominantly been in India. It is specified that in case the assessing officer proposes to hold a company's POEM in India, he shall do so after seeking prior approval of the Principal Commissioner or the Commissioner, who in turn shall, before deciding the matter, give an opportunity of being heard to the company.

#### IV. Comments/ Observations on the Guidelines

Since the determination of the 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 Guidelines. There are certain observations/comments on the Guidelines, which have far reaching implications and need reconsideration:

- There is no guidance provided in the Guidelines with respect to the meaning of certain expressions such as 'key management and commercial decisions', 'for conduct of the company's business as a whole', 'primarily or predominantly', *etc.* Being subjective, these expressions are subject to diverse interpretation and may become the cause of protracted litigation.
- 'Passive Income' defined in the Guidelines includes royalty, dividend, interest income, *etc.* and applies to all companies irrespective of the nature of its activities. While certain activities may form part of integral operations of a company and income thereon may be classified as active income, same activities may be non-integral for other companies and hence would be categorised as passive income. For instance, financing and lending activities for banks or financial institutions form part of its core business operations and therefore, interest income by no stretch of the imagination could be classified as passive income. The passive income test must also be supplemented with the activities of the company else the wide scope of interpretation would lead to absurd results. Similar problems do exist in categorisation of royalty, dividend, and rental income as well.
- Similarly, incomes from transactions where purchase and sale are from/to its associated enterprises are also classified as passive income in the Guidelines. Such transactions between associated enterprises can be genuine commercial transactions forming part of the core business operations and ought not to be classified as passive income. Such classification may lead to unwarranted consequences for genuine companies including foreign companies with legitimate business operations outside India.

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- The Guidelines state that while considering ABOI, the passive income of the company should not be more than 50% of the total income. The Guidelines are silent as to how the total income is computed for satisfying this test. Essentially, total income refers to the income computed in accordance with Section 5 read with Section 2(24) of the Act. However, in case if total income as per the Act is considered, there is a possibility that the proportion of passive income *viz-a-viz* the total income may be misleading. Moreover, computing total income for foreign companies would also be an onerous obligation.
- The Guidelines also state that a company is treated as engaged in ABOI if its total assets situated in India are less than 50%. However, there is no clarity as to whether the 'total assets' refers to the book value, the market value or the written down value. Similarly, there is no clarity as to what is encompassed within the purview of payroll expenses and how is it to be computed. Since there are no clear guiding principles outlined w.r.t. such issues, it shall be subject to diverse interpretation and may also yield different results.
- 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 Guidelines also acknowledge the fact that the physical presence of a person is no longer necessary to run a business, in view of sophisticated telecommunication technology. The Guidelines on this aspect recommend that the place where the persons taking the decisions usually reside may also be a relevant factor in determining POEM. POEM determination on the satisfaction of this condition may be practically difficult since it is possible that the persons taking the decisions may reside in different geographic locations.
- It is specified in the Guidelines that if POEM cannot be clearly identified, secondary factors i.e. the place where main and substantial activities of the company are carried out and the place where accounting records of the company are kept, would have to be considered. Firstly, the expression 'main and substantial activity' is not defined and may be subject to diverse interpretations. Also, in the era where real time access of the accounts are available and



books are maintained electronically which can be accessed through servers located anywhere, application of such secondary factors may give rise to contradictions.

- The Guidelines provide that based on the facts and circumstances of the case, if it is determined that during the year, POEM of a company is both in India as well as outside India, then POEM shall be presumed to be in India if it has been mainly/predominantly been in India. It would be relevant to note that the issues of dual residency remain unaddressed and the Guidelines if made effective as is without careful calibration would result in protracted litigation.

## V. Parting Thoughts

One hopes that the Board will take note of the above concerns emanating from the Guidelines and at the same time ensure that appropriate changes are made and final guidelines issued at the earliest. Considering the fact that the amendment to provisions of Section 6(3) by the Finance Act, 2015 are applicable from 1st April, 2016 and the final guidelines are yet to be released, it is anticipated that the applicability of POEM provisions are made applicable from financial year 2016-17. At the outset, the efforts by the Board in drafting comprehensive guidelines must be complemented and the final guidelines once released would certainly clear the existing apprehensions and bring in the much desired clarity with a view to mitigate the foreseeable protracted litigation. ■