Determining "Place of Effective Management" – A Critical Analysis

Under the provisions of the Income Tax Act, 1961 ("the Act"), the residential status of a "Company" (the term is wide enough to cover all body Corporate incorporated outside India) right from the inception of the Act in 1961 was based on the place where "control & management" of the affairs was situated. However, the Finance Act, 2015 read with Finance Act, 2016 have amended this definition w.e.f. 1st April, 2017 i.e. A.Y. 2017-18. The Explanatory Memorandum of the Finance Bill, 2015 states that the rationale behind this amendment was to discourage creation of shell companies outside India but controlled from India. It further justified this amendment on the grounds that Place of Effective Management (hereinafter referred to as "POEM") is an internationally recognised concept for determination of residence of Companies & is also recognised and accepted as a tie-breaking test in Organisation for Economic Co-operation & Development (OECD) Model Treaty as well as in most of the double tax treaties. Read on to know more…

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Background

The Finance Act, 2015 read with Finance Act, 2016 have amended the definition of residential status of a company w.e.f. 1st April, 2017 i.e. A.Y. 2017-18 in the following manner:

"A company is said to be 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."

Explanation— For the purposes of this clause "place of effective management" means 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.

An attempt is made in this brief article to:

i) Evaluate whether India needs/is ready for the POEM Concept;

ii) Critically analyse the draft guiding principles issued by CBDT (for determining POEM) with a view to identify its short-comings ;

iii) And finally to benchmark these draft guiding principles against the guiding principles issued by some other countries with a view to suggest best practices.

I. Is India ready for the Introduction of POEM?

The Finance Minister has justified this amendment on the grounds that POEM would discourage creation of shell companies outside India by residents and that POEM is an internationally recognised concept for determination of residence of Companies & is also recognised and accepted as a tie-breaking test in OECD Model Treaty as well as in most of the double tax treaties.

In my view, there was no real urgency or need to introduce the POEM concept in Indian domestic law especially when Indian entrepreneurs are just about making initial attempts to test offshore waters. Test for residency is nowhere in the world used as an anti-avoidance tool. Some of the factors which seem to have been overlooked before introducing POEM in the Income Tax Act,1961 are:

i) The mere fact that POEM is prevalent in other countries is not a justification for introducing it in India. In most of these countries the tax system is not adversarial to the tax payer and the risk of litigation is lower than in India. Companies do not generally consider POEM as a risk factor while managing their global operations as for a long period jurisprudence there is well settled. Countries such as the US focus on the place of incorporation and do not bother about whether a non-US company is effectively controlled in the US.

ii) Unilateral approaches often result in double taxation since there is no guarantee that the other country will accept India's determination of a company's POEM. This risk is more significant for US companies founded or held by India based entrepreneurs since the US tax treaty does not recognise the concept of POEM. Say for Eg. Company X is incorporated in United States of America (USA) and on the basis of it being incorporated over there; it becomes a resident in USA. However, The Income Tax authorities in India, on the basis of facts and circumstances, determine the POEM of Company X in India. Therefore, Company X becomes resident in two countries; As the tax treaty between India-USA does not clearly specify the tie-breaking rules, there should be more comprehensive rules and conventions laid down to avoid such situations in the final guiding principles to be issued by the CBDT.

iii) Litigation risks in India have been a sore point for investors and the Government has in the recent past made some positive attempts to reign in high pitched and frivolous tax assessments. The root cause for uncertainty and litigation is subjective and ambiguous tax rules. With provisions such as the general anti-avoidance rules (*"GAAR"*) dealing with cases of taxpayer abuse, it may be difficult to be too objective. But, something as fundamental as a company's residence should not be a matter of subjectivity. There is no sense in replacing the earlier 100 year old rule for corporate residence that ensured maximum certainty without creating double taxation outcomes for companies.

iv) A number of tools may be deployed by tax authorities to counter abusive cross-border structures, which include transfer pricing, GAAR, treaty based anti-conduit or limitation of benefits criteria and others. POEM is not

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such a tool. For taxing overseas subsidiaries located in tax havens, India may in the future introduce controlled foreign corporation ("CFC") rules after ensuring full credit for foreign taxes.

II. Critical Analysis of the Draft Guiding Principles for determination of a Place of Effective Management of a Company:

The Central Board of Direct Taxes ("CBDT") has issued on 23rd December, 2015 "Draft Guiding Principles for determination of a Place of Effective Management of a Company" and has invited public comments.

a) A summary of the draft guiding principles issued by CBDT is set out below:

i) The draft guidance emphasises that the test of POEM is one of substance over form and will depend on facts and circumstances of each case. While a company may have more than one place of management, it can only have one place of effective management at any point in time.

ii) The guidance contemplates different tests for companies with active and passive businesses outside India. An active business outside India is one where less than 50% of the total assets are situated in India and less than 50% of the income is passive and less than 50% of its employees are situated in India, with payroll expenses on such employees being less than 50% of total payroll expenses. Passive income covers dividends, interest, royalties, capital gains, rent and income from related party transactions.

iii) *The POEM for an active company* is presumed to be outside India if the majority of its Board meetings are held outside India. This presumption would not apply if management authority is exercised by a person other than the Board, who is resident in India. This determination will be based on data over the past 3 years, or lesser if the company has been in existence for lesser than 3 years.

iv) To determine the POEM of passive companies, the persons who actually make key management and commercial decisions for the business as a whole will be identified, followed by identifying the place where decisions are actually taken.

The following guiding principles would be considered for determining the place where such key management and commercial decisions are made:

- Location where the Board regularly meets, provided it retains and exercises governing authority over the company and in substance takes key management and commercial decisions.
- The place where key decisions are in fact taken would have more relevance than where formal Board meetings are held.
- If the Board routinely ratifies decisions made by senior management, executive committee or any other person, the place where such person takes decisions will be considered as POEM.
- The location of a company's head office is an important factor and the following facts have to be considered in this regard: (i) Location where the company's senior management and support staff are based and which is held out to the public as its headquarters. (ii) In a more decentralised company, the head office would be the place where the senior management is predominantly based, normally return to after travel, or meet when formulating key strategies or policies for the company as a whole. (iii) If senior management permanently operate from different locations, and participate in meetings via telephone or video conferencing, the location of the highest level of management such as the managing or financial director

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will be considered as the head office. (iv)The head office would not be of much relevance in a highly decentralised company where it is not possible to determine its location with reasonable certainty.

- Day to day routine operational activities of junior or middle management is not relevant for determining POEM.
- With the use of modern technology, physical location of meetings may not be where the key decisions are in substance made. In such situations, place of residence of majority of directors or decision making persons may also be a relevant factor.
- As secondary factors, place of main and substantial activity of the company and place where accounting records are kept may be considered if the primary factors are inconclusive.
- Ownership of a foreign company by an Indian company, residence of some of the directors of the foreign company in India, location of local management of a foreign company in India and existence of support functions of preparatory or auxiliary character in India will not be conclusive of POEM in India.

v) The above principles are only for guidance and no single principle will be conclusive. Activities performed over a period of time during a financial year should be considered rather than a 'snap shot' approach.

vi) The tax officer will require prior approval from the Principal Commissioner or the Commissioner before treating a foreign company as a resident based on POEM and the foreign company shall be provided an opportunity of being heard before a decision is made.

b) Critical Analysis of the Draft Guiding Principles:

i) The draft guiding principles seek to provide different test for active business & passive business despite the fact that the Act does not provide for any such distinction. We also find that in other countries where residency is based on POEM, this type of distinction i.e. active and passive business does not exist. This distinction is unwarranted & seems to be motivated with a view to bring in the concept of *"Controlled Foreign Companies"* (CFC) through the back door.

The tax officer will require prior approval from the Principal Commissioner or the Commissioner before treating a foreign company as a resident based on POEM and the foreign company shall be provided an opportunity of being heard before a decision is made.

ii) In para 5(a)(i), it should be clarified that the average of the opening and closing balances in Balance Sheets of the foreign entity will form the basis of determining 50% of total assets.

iii) In para 5(c), it should be clarified that "interest" income of a bank and/or entity whose main business is of lending funds will not be considered as "passive" income.

iv) Para 7 provides that Active Companies shall be presumed to have a POEM outside India, if the majority of the Board meetings are held outside India. However, Para 7.1 provides for a subjective carve out and one dimension of that carve out is that, if it is established that the Board of Directors acts like a rubber stamp and such powers are exercised by either the Holding Company or any other person resident in India, then the POEM shall be considered to be in India.

In this context, it is recommended that:

- The term "any other person resident in India" is vague and should be removed. There will be some cases where a person resident in India may engage with senior personnel of the Foreign Company during the course of overseas visits to take some decisions abroad, which should not trigger POEM in India as these decisions are not made on a regular basis.
- It should be made expressly clear that this carve out for exercise of powers by Holding Company is only where a majority of such decisions are being taken by the Holding Company.
- It should also be made expressly clear that the onus of proof to prove that such decisions are being taken in India is on the tax department.

- Guidance needs to be provided as to how the data of the previous years will be used, when the financial year of the Foreign Company is different from Indian financial year.

v) Para 8.2 (f) in the context of Passive Companies effectively talks of a tie- breaker test where there is no clear identification of POEM. However, Para 10(last portion) talks of a situation where the POEM is in India and outside India, and in such circumstances, 'it being presumed to be in India if it has been mainly/predominantly in India'. This contradicts Para 8.2 (f) part of the guidance and therefore leads to ambiguity for the tie- breaker test. This needs to be relooked.

vi) POEM trigger should be tested on a hierarchal test basis. In other words, there should be a clear decision tree for a company (in the manner of a tie-breaker test) to decide whether there is a POEM trigger. Further, the guidelines defined for determination of POEM in case of Foreign companies having passive business does not clearly mention whether all the conditions needs to be satisfied or satisfaction of any one condition is sufficient.

vii) A listed Foreign Company is considered to be having active business in that country and therefore exception should be provided from the Active Business Determination and such companies should be considered as Non-resident in India.

viii) Active Business Test is a critical test to eliminate companies from creating a POEM in India. The current rules do not include companies that are listed outside India. Listing is a key criterion in many of the treaties in determining whether a company is active or dormant. This should be included in the elimination criteria as a part of Active Business Test.

ix) With the advancement of technology, accounts of a company are maintained online and could be even maintained by a third party service provider overseas. This clearly cannot be a factor in deciding POEM trigger.

III. Bench Marking Guiding Principles with those of Other Countries:

We found that Russia, China and South Africa are the major countries where they have POEM as the

residential test for Companies. We summarise below the guiding principles followed in these companies:

RUSSIA	SOUTH AFRICA	CHINA
Foreign Company will be deemed to be resident in Russia if at least one of the primary condition is satisfied:- - Majority of BOD meetings are in held in Russia; or - Executive management of the Company is regularly exercised in Russia; or - Top management functions are exercised by key corporate officials in Russia; or If it is not possible to determine the residency of foreign company on the above criteria then POEM will be considered in Russia if any of the following secondary criteria is satisfied:- - Preparation of A/c's in Russia; or - Operational personnel management is conducted from Russia; or - Work paper management is conducted from Russia; or **Exemptions:-** - The company is a tax resident in a foreign country in accordance with a double tax treaty concluded between Russia and South Africa; - The CFC is part of profit-sharing agreements, concession, licensing or service agreements similar to profit-sharing agreements, or other agreements with the government or other state authorities\state companies of the respective country - The foreign company acts as the operator of a new offshore oil field or is a shareholder of such an operator; - The foreign company is the issuer of traded Eurobonds, while the share of income from such activities is not less than 90%; - A Russian controlling person owns directly or indirectly 50% or more of the share capital in the foreign company for at least 1 year subject to fulfillment of conditions	A company's POEM is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. If those decisions are made at more than one location, the company's place of effective management will be the location where those decisions are primarily or Predominantly made. The following factors can be considered while determining POEM of a foreign entity:- - The location of a Company's Head Office where senior management and support staff are predominantly located - If the Board routinely ratifies decisions made by senior management, executive committee or any other person, the place where such person takes decisions will be considered as POEM. - The place where Board regularly meets and makes decision in substance necessary for the conduct of business - In the era of technology, undue focus on location of board meetings should be placed considering the facts of the case - Operational management decisions are of limited relevance in determining POEM - Legal factors such as place of incorporation, formation or registered office are generally not relevant in determining POEM - The extent of a Company's economic nexus with a country is not relevant in determining POEM, however some weight shall be given to this if other factors seem inconclusive - The location of support services is of least relevance **Exclusions:-** - Person who is deemed to be exclusively a resident of another country in accordance with a double tax treaty concluded between Russia and South Africa;	An Overseas Incorporated Domestically Controlled Enterprise (OIDCE) which satisfies all of the following conditions shall be considered to have its POEM in China and recognised as a resident enterprise: - Senior management responsible for the enterprise's daily production/ business operations are mainly located in the People's Republic in China (PRC) the senior management executes its responsibilities mainly from the PRC; and - Strategic financial and HR decisions are made or approved by organisations or personnel located in the PRC; and - Major properties, accounting records, company stamps, Board/ shareholder's meeting minutes, etc. are maintained in the PRC ; and - 50 percent or more of the Board members with voting rights or senior management habitually reside in the PRC; and PRC withholding tax (WHT) shall be levied on dividend distributed by the OIDCE to the foreign investor whereas the dividend distributed between the China Enterprise and OIDCE will be exempt from tax. Enterprises invested in the PRC by the OIDCE shall still be treated as a foreign-invested enterprise from a PRC tax perspective if the foreign shareholding (including investments held by the OIDCE) is at least 25 percent. An OIDCE shall not be subject to the controlled foreign company (CFC) rules. However, overseas enterprises which are controlled by it shall be subject to the CFC rules. In case of dual residency, the Provisions in the double taxation agreement which China has entered into with the relevant country shall be relied upon.

IV. Suggestions

i) Exemption from applicability of POEM should be provided for certain foreign companies eg. If the foreign company is incorporated in jurisdiction having a tax rate of say 15% or higher. In such cases, the "control & management" test, which previously existed, should be considered.

ii) A foreign company being taxed as resident on account of POEM should be allowed to claim FTC if the income is doubly taxed.

iii) The guiding principles provided by India are clearly swayed by the South African guidance on determination of POEM. In my view, the guiding principles for determination of POEM as provided by China seem to be relatively more practical. I would urge the CBDT to have a close look at the Chinese guidelines) before finalising the Indian guidelines. ■