



Place of Effective Management



Simplify > Accelerate > Grow

Introduction:

As per the Income-tax Act, 1961 (hereinafter referred to as “the Act”), global income of the person resident in India is chargeable to tax in India¹. Further, all income of the non-resident person is chargeable to tax in India if the income is received or deemed to be received in India or accrues or deemed to accrue or arise in India². Determination of residential status of company is governed by Section 6(3) of the Act.

Determination of residential status of the person defines the scope of taxpayer’s taxable income. Under the Act, a person resident in India is taxed on income derived from both domestic and foreign sources, whereas a person non-resident in India is only taxed on the Income that has its source in India (i.e. received or deemed to be received in India or accrues or deemed to accrue or arise in India).

Each country has its own local taxation law to determine the residential status of the person for their country. Such law could be different from Indian taxation law governed by the Act. There have been instances that the same income has been subject to double taxation on the principle of taxing an income based on the residency rule as well as source of the Income. There have been instances that the person is resident in two different countries based on the local taxation law. In order to curb inconvenience caused to taxpayers on account of difference in tax law of different countries, countries enter into Double taxation Avoidance Agreement (hereinafter referred to as “DTAA” or “treaty”). The main purpose of DTAA is to avoid such double taxation.

Introduction – An Indian Perspective:

Determination of residential status of company is governed by Section 6(3) of the Act. Prior to amendment of Section 6(3) of the Act by Finance Act 2015, the company was said to be resident in India during the previous year, if it is an Indian company, or if during that year, the control and management of its affairs is situated wholly in India. Finance Act 2015 amended Section 6(3) w.e.f. 01 April 2016, applicable from assessment year 2016-17 (hereinafter referred to as “A.Y.”) to provide that a company is said to be resident in India in any previous year, if it is an Indian company, or its place of effective management in that year is in India. Finance Act 2016 deferred the effectivity of the amendment by one year and the amendment is not effective w.e.f. 01 April 2017 and applicable for AY 2017-18 onwards. Chapter XII-BC has been inserted by Finance Act 2016 w.e.f. 01 April 2017 and applicable for AY 2017-18 onwards, containing special provisions relating to taxability of the foreign companies regarded as resident in India³ by virtue of determination of its place of effective management (hereinafter referred to as “POEM”) being situated in India.

¹ Section 5(1) of the Act

² Section 5(2) of the Act

³ Section 115JH of the Act

Introduction to Place of Effective Management:

The OECD Model Tax Convention (hereinafter referred to as "OECD Model") provides the tie-breaker rule by way of determination of POEM of that company and prevent double taxation of a particular income which is proposed to be taxed by virtue of company being resident in more than one contracting state. POEM is an internationally recognized test for determination of the residential states of the company that is incorporated in a foreign jurisdiction. Article 4(3) of the OECD Model states that "where by reasons of the provision of paragraph 1 a person other than individual is resident in both contracting state, then it shall be deemed to be a resident of the State in which its place of effective management is situated. The Commentary on Article 4 of the OECD Model, POEM is the place where key management and commercial decisions where key management commercial decisions that are necessary for the conduct of the entity's business as a whole are, in substance, made⁴. The OECD Model also states that all relevant facts and circumstances must be examined to determine the POEM. An entity can have more than one place of management, but it can only have one place of effective management.

Guidelines for Determination of POEM:

On 23 December 2015, the Central Board of Direct Taxes (hereinafter referred to as "CBDT" or "Board") issued draft guidelines providing guidance on determination of POEM. These guidelines were open for public comments till 2 January 2016. The Guidelines were finalized by the CBDT on 24 January, 2017 vide Circular No. 06 of 2017. Key highlights of the Circular are highlighted hereunder:

Definitions:

Active Business Outside India

A company shall be said to be engaged in "active business outside India" if the passive income is not more than 50% of its total income; and

- (i) less than 50% of its total assets are situated in India; and
- (ii) less than 50% of total number of employees are situated in India; and
- (iii) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure

For the purpose of determining whether the company is engaged in active business outside India, the average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such period shall be considered. Where the accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the previous year, then, data of the accounting year that ends during the relevant previous year and two accounting years preceding it shall be considered

⁴ Page C4(8) – Para 24 of the OECD Model Convention – As Amended on 17 July 2008

Our Comments:

The draft guidelines had not provided any clarity with respect to terms like “total assets”, “total income”, “computation of total employees”, etc. However final guidelines has defined such terms. They are as under:

Income:

the income shall be, -

- (a) as computed for tax purpose in accordance with the laws of the country of incorporation;
- (b) as per books of account, where the laws of the country of incorporation does not require such a computation

Value of Assets

the value of assets, -

- (a) In case of an individually depreciable asset, shall be the average of its value for tax purpose in the country of incorporation of the company at the beginning and at end of the previous year;
- (b) In case of pool of fixed assets being treated as a block for depreciation, shall be the average of its value for tax purpose in the country of incorporation of the company at the beginning and at end of the previous year;
- (c) In case of any other asset, shall be its value as per books of account;

Number of Employees:

the number of employees shall be the average of the number of employees at the beginning and at the end of the year and shall include persons, who though not employed directly by company, perform tasks similar to those performed by the employees.

Payroll:

the term “payroll” shall include the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.

Passive Income

“Passive Income” of a company shall be aggregate of, -

- (i) Income from the transactions where both the purchase and sale of goods is from / to its associated enterprises; and
- (ii) Income by way of royalty, dividend, capital gains, interest or rental income

However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation.

Our Comments:

Final guidelines have clarified that the interest income arising to a banking or public financial institution shall not be considered in computation of passive income.

Guiding Principles:

The Guideline provides various guiding principles for determination of POEM⁵:

Place of Board Meeting:

The location where a company's Board regularly meets and makes decisions may be the company's POEM subject to the conditions that the Board retains and exercises its authority to govern the company and the board, in substance, make the key management and commercial decision necessary for the conduct of the company's business as a whole. It has further been clarified that if the key decisions by the board are taken at a place other than the place where formal meetings are conducted, such other place shall be taken into consideration for determination of POEM. It has also been clarified that merely because the board follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of payroll functions, accounting, human resource (HR) functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group of entities per se, it would not constitute a case of the board of directors standing aside and not exercising the power of management.

Delegation of the Authority by the Board of Directors:

If a board has delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder, promoter, strategic or legal or financial advisor, etc. and does nothing more than routinely ratifying the decisions made by such person, the POEM of the company shall ordinarily be the place where these senior managers or such other persons make those decisions.

Senior Management of the company has been defined at Para 5 (d) of the Circular to mean the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies and policies on a regular and on-going basis. These persons may include Managing Director or Chief Executive Officer, Financial Director or Chief Financial Officer, Chief Operating Officer and heads of various divisions or department (for eg. Chief Information or Technology officer, Director for Sales or Marketing).

The delegation of the authority by the board can be either *de jure* (by means of a formal resolution or Shareholder Agreement) or *de facto* (based upon the actual conduct of the board and the executive committee).

⁵ Para 8.2 of the Circular No. 06 of 2017 on Guiding Principles for determination of Place of Effective Management of the Company

Location of Head Office:

The location of the company's head office is an important factor in the determination of the company's POEM because it often represents the place where key company decisions are made. Head office has been defined at Para 5(b) of the circular to mean a place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.

If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers,-

- (i) are primarily or predominantly based; or
- (ii) normally return to following travel to other locations; or
- (iii) meet when formulating or deciding key strategies and policies for the company as a whole

In situations where senior management is so decentralized that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office for the purpose of determination of POEM would not be relevant.

Impact of Modern Technology:

With the advent of modern technologies like video conferencing, it is no longer necessary for the persons taking decision to be physically present at a particular location. Therefore, physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being 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.

Decision by Circular Resolution:

In case of decision taken by circular resolution, the factors like the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered for determination of POEM. It cannot be said that proposer of decision alone would be relevant but based on past practices and general conduct; it would be required to determine the person who has the authority and who exercises the authority to take decisions. The place of location of such person would be more important.

Shareholder's Decision:

The decisions made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's place of effective management. Such decisions may include sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. These decisions typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company's business from a management or commercial perspective and are therefore, generally not relevant for the

determination of a company's place of effective management.

However, the shareholder's involvement can, in certain situations, turn into that of effective management. This may happen through a formal arrangement by way of shareholder agreement etc. or may also happen by way of actual conduct. Therefore, whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis.

Place of Implementation of strategic management decisions not relevant for determination of POEM:

For the purpose of determination of POEM, the place where such strategic decisions as mentioned above are more relevant as compared to place where such decisions are implemented. Decisions taken by middle / junior management for implementing such decisions are not relevant factors for determination of POEM for a company.

Secondary Factors:

If the above guiding factors do not lead to clear identification of POEM then, secondary factors like place where main and substantial activity of the company is carried out; or place where the accounting records of the company are kept can be taken into consideration for determination of POEM.

Certain Factors not relevant or conclusive to establish that POEM is situated in India:

Guidelines has emphasized that determination of POEM is to be carried out in wholistic basis after considering all relevant facts related to the management and control of the company; and it should not be determined on the basis of some isolated facts merely because:

- (i) A foreign company is completely owned by an Indian Company;
- (ii) There exist a permanent establishment of a foreign entity in India;
- (iii) One or some of the Directors of the foreign company reside in India;
- (iv) Local Management being situated in India in respect of activities carried out by a foreign company in India;
- (v) The existence in India of support functions that are preparatory and auxiliary in character;

Principles are only Guiding Factors

The circular has clarified that the principles are for guidance only and no single principle will be decisive in itself. The circular has provided that "snapshot approach" should not be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly or predominantly in India.

Administrative Procedure:

Before initiating any proceedings for holding a company incorporated outside India, on the basis of its POEM, as being resident in India, the assessing officer (hereinafter referred to as "AO") has to seek prior approval of the Principal Commissioner or the Commissioner, as the case may be. Further, in case the AO proposes to hold a company incorporated outside India,

on the basis of its POEM, as being resident in India then any such finding shall be given by the AO after seeking prior approval of the collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned, in this regard. The collegium so constituted shall provide an opportunity of being heard to the company before issuing any directions in the matter.

Our Comments:

India has been a firm believer of **substance over form** and the tax authorities have now and again lifted the corporate veil of the company to determine the economic substance of the transactions undertaken by multinational groups. The concept of POEM is also based on substance over form. The circular is in line with the OECD Model and reiterates the position that an entity may have more than one place of management, but it can have only one place of effective management at any point of time.

The rationale behind introduction of POEM is to bring more multinational groups under the tax net (especially groups operating under off-shore model) and secondly to bring the Indian law in line with OECD Model. Although India has been an observer to OECD, India has always maintained the stand that determination of POEM should be governed by the factors leading to the place where main and substantial activity of the company is carried on.

Though the circular has given guiding factors in determination of POEM of the company, clarifications are still required on various factors as under:

Transfer Pricing Provisions:

Chapter X of the Act deals with Transfer Pricing Regulations covering the transaction of purchase and sale of goods between the associated enterprises⁶ as defined under Para 5(c) of the circular i.e. Passive Income. Clarification is required in case where an associated enterprise of an Indian Entity is determined to have a place of effective management in India as to whether transfer pricing provisions would be applicable to such entities? Further, clarification is required whether transactions by such entity with other group companies outside Indian jurisdiction would be subject matter or transfer pricing and requires determination of arm's length price under Indian Transfer Pricing Regulations? If such transactions are also covered under the ambit of Transfer Pricing Regulations, it would unnecessarily increase the compliance burden on such entities.

Credit on Foreign Taxes Paid:

Clarification is required as to how India will grant relief under section 90 of the Act in respect of taxes paid outside India for the entities for which POEM has been determined to be situated in India.

Applicable Rate of Taxes:

Rate of tax applicable to domestic companies is at the basic rate of 30 percent whereas rate of tax applicable to foreign companies is at the basic rate of 40 percent. Clarification is required in the case where a foreign company is determined to have POEM in India with respect to applicable rate of taxes.

Action Plan 6 – Final Report under OECD Base Erosion and Profit Shifting (“BEPS Project”)

Action Plan 6 of the Final Report of the BEPS project has recommended replacing article 4(3) of the OECD Model by providing competent authority of respective contracting states to determine the residence rule by mutual agreement having regard to POEM, place of incorporation or constitution and any other relevant factors.

Rate of Tax on Dividend Distribution Tax:

Clarification is required in the case where a foreign company is determined to have POEM in India with respect to applicable rate of dividend distribution taxes by such company to its Indian Parent and whether concessional rate of tax under section 115BBD would be applicable. Further clarity is required in case where Dividend Distribution Tax is paid by Indian Parent company, would the credit be available in an event or receipt of Dividend by Foreign Company which is determined to have POEM in India.

Conclusion:

The concept of place is effective management is not an exact science and as the circular has reiterated the principle just have a persuasive value and determination of POEM has to be seen on case to case basis only. The concept of POEM cannot be straight-jacketed into a single formula to determine the POEM on fulfillment of certain conditions. The POEM must be determined based on the facts and circumstances of the case after looking into the activities of the foreign company as a whole and in substance. CBDT has given few illustrations which will help as a guiding principle in determination of POEM of a company.

The concept is still at a nascent stage and how the law will evolve, only time will tell.

About Author

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⁶Section 92A of the Act

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