Tax Hotline

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PLACE OF EFFECTIVE MANAGEMENT - REVISED GUIDELINES ISSUED: INHERENT SUBJECTIVITY STILL A CONCERN

- Indian tax authorities release final guiding principles for the determination of the 'place of effective management' of a foreign company.
- Provides clarity on application of 'active business outside India' test.
- Permanent Establishment in India will not automatically result in POEM in India for foreign company.
- Decisions on matters statutorily reserved for shareholders under company laws not relevant for determination of POEM. Some clarity on decisions reserved for shareholders under contract.
- Guidance on difference between operational decisions and key management and commercial decisions.
- Two-step approval process for initiation of proceedings to determine POEM.

Recently, on January 24, 2017, the Central Board of Direct Taxes ("**CBDT**") issued a circular[1] containing what appear to be the final guiding principles ("**Revised Guidelines**") to be taken into account during the determination of the 'place of effective management' ("**POEM**") of a foreign company.

The Revised Guidelines build on the draft guidelines ("**Draft Guidelines**") released for public comment by the CBDT on December 23, 2015. Our hotline analyzing these Draft Guidelines can be found here. The Revised Guidelines, which will be relevant for determining whether, for the purposes of this financial year ("**FY**") 2016-17 and all future FYs, a foreign company could be considered to have its POEM situated in India, and accordingly be regarded as a tax resident of India, come after almost two years have elapsed from the date on which Draft Guidelines were released, and a mere two months before the end of this FY 2016-17.

BACKGROUND

Earlier under Section 6(3) of the Income Tax Act, 1961, ("**ITA**"), a foreign company was regarded as a tax resident of India only if it was 'wholly controlled and managed' in India. This test of residence was both objective and predictable for the taxpayers.

In 2015, the Finance Act amended Section 6(3) of the ITA to provide that a foreign company would be considered to be a tax resident of India if its' POEM[2] was found to be situated in India (the "**POEM Test**"). When introduced, the POEM Test was slated to come into effect from April 1, 2015 i.e., FY 2015-16 onwards. However, due to the fact that the Draft Guidelines were released a mere three months before the end of FY 2015-16, it left taxpayers with very little time to set their affairs in order. The Finance Act, 2016 therefore deferred its entry into force by a year i.e., to April 1, 2016. Despite this, taxpayers were provided with a narrow window of only two weeks to provide their comments and concerns in relation to the Draft Guidelines.

Now, even the Revised Guidelines have been issued with only a couple of months left in the FY for companies to set their affairs in order and, although there has been an attempt to address some of the concerns raised by stakeholders, the uncertainty and subjectivity inherent in the POEM Test remain.

THE REVISED GUIDELINES

1. Substance over Form - Isolated facts to be ignored

The Revised Guidelines are consistent in their emphasis on substance over form, and maintain that a determination of POEM will depend on facts and circumstances of each case. They reiterate that no single guiding principle will be decisive and that activities performed by a foreign company over a period of time will be considered. Further, while the Revised Guidelines continue to shun a 'snapshot approach' based on isolated facts that do not establish effective management to determine POEM, they now explicitly state that the mere existence of a permanent establishment of a foreign company in India would not be conclusive evidence that the conditions for establishing POEM have been satisfied. Earlier clarifications in the Draft Guidelines, that state that having Indian directors, local management in India or Indian support function would not be conclusive of POEM in India, have been retained.

2. Clarity on Active Business outside India (ABOI) Test

The Revised Guidelines retain the distinction between companies that carry on an 'active business outside India' ("**ABOI**") and companies that do not. Foreign companies carrying on an ABOI benefit from a presumption that their POEM is outside India (provided a majority of the board meetings of such company take place outside India, and the

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board actively exercises its powers of management). The Revised Guidelines clarify that in the case of companies that are part of a global group of companies, the mere fact that the Board follows general and objective principles of global policy[3] of the group laid down by the parent entity (which are not specific to any entity or group of entities) would not result in the Board being regarded as not actively exercising its powers of management or standing aside.

While, the tests to determine whether a foreign company is engaged in an ABOI remain the same i.e. (i) less than 50% of the its income is passive, (ii) less than 50% of its assets are situated in India, (iii) less than 50% of its employees are situated in India; and (iv) payroll expenses incurred on such employees comprise less than 50% of its total payroll expenses, the Revised Guidelines have now clarified the meaning of the various terms used in these tests:

1. 'Payroll' has been defined to include salaries, wages, bonus and all other employee compensation including related pension and social costs borne by an employer.
2. 'Value of assets' has been defined to mean (a) in the case of a depreciable asset (or block of depreciable assets), the average of the value of such asset (or block of assets) for tax purposes in the country of incorporation of the foreign company at the beginning and at the end of the relevant previous financial year, and (b) in any other case, the value of the assets in the books of the foreign company.
3. 'Number of employees' has been defined to mean the average of the number of employees of the foreign company at beginning and at the end of the year and will include persons, who though not employed directly by the company, perform tasks similar to those performed by employees.
4. 'Income' should be calculated as per the laws of the country of incorporation of the foreign company or, where the country of incorporation does not require such computation, as per such company's books of accounts.

Further, the Revised Guidelines clarify that in cases of foreign companies incorporated in jurisdictions where the tax accounting year differs from the Indian financial year i.e., April 1 – March 31, data of the accounting year which ends during the relevant previous financial year and the two accounting years preceding it should be considered for the purpose of applying the ABOI test.

Notably, the Revised Guidelines have carved-out interest income received by public financial institutions and regulated banking companies.[4]

3. Additional Guiding Principles Introduced

Foreign companies that do not meet the ABOI test are subject to a two-step test to determine POEM. Step 1 involves the identification of the persons who make the key commercial or management decisions of such company, while step 2 involves determining the place where such decisions are made. For the purpose of ascertaining these, the Revised Guidelines have added certain principles, which are in addition to those already present in the Draft Guidelines.

(a) Key Managerial Decisions or Decisions of Commercial importance

The Draft Guidelines simply stated that day to day routine operational decisions by junior and middle management would not be a key commercial or management decision. The Revised Guidelines now clarify that the term 'day-to-day routine operational decisions' relates to oversight of day-to-day business operations and activities, while 'key management and commercial decisions' are those concerned with broader strategic and policy decisions. An illustrative example has also been provided to help taxpayers understand the difference: whereas decisions to open a major new manufacturing facility or discontinue a major product line would be key management and commercial decisions, decisions concerning repair and maintenance, implementation of quality controls and human resources policies would be routine operational decisions. Where the same person is responsible for both types of decisions, The Revised Guidelines state that it would be necessary to distinguish between the two types of decisions, and thereafter determine the location where the key management and commercial decisions are taken.

(b) Exercise of powers by Holding Companies and Shareholders

The Revised Guidelines state that merely because a majority of the shareholding of a foreign company is held by Indian residents, this alone would not suffice to establish that POEM of such company is in India. As mentioned earlier, it would be necessary to establish that the Board of such company is not actively engaged in the management of the company and / or are standing aside while the shareholders[5] exercise real control.

Importantly however, the Revised Guidelines state that reserving certain decisions for shareholders would not amount to POEM in every instance. The Revised Guidelines recognize that decisions reserved for shareholders are usually associated with the existence of the company itself or the rights of the shareholders themselves, such as decisions on sale of most or all of the assets of the company, dissolution or liquidation of the company, modification of rights attaching to various classes of shares etc. The Revised Guidelines rightly state that since such decisions are not concerned with the company's business from a management or commercial perspective, they should not be relevant for determining POEM. However, the Revised Guidelines do provide that where the authority of the Board and senior management of the Company is limited due to the number and nature of decisions reserved for shareholders and the company's real authority to make the decision is curtailed, such decisions would become relevant for determining POEM.

Regardless of the above, the Revised Guidelines provide that decisions that are statutorily required to be taken by shareholders under any law such as the Companies Act are not to be considered as key management or commercial decision or as constraining the powers of the Board.

Notably, through one of the illustrative examples included in the Revised Guidelines, it has been clarified that the fact that the POEM of an intermediary holding company is in India would not necessarily result in the POEM of its subsidiaries' being in India.

(c) Location of Board Meetings and Circular Resolutions

The Revised Guidelines clarify that in cases where decisions are taken by way of a circular resolutions, where directors are in separate locations, it would not be only the location of the person proposing the decision that is

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

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relevant, but location of the persons who have and who exercises the authority to take decisions, as well as the types and frequency of decisions made through this method that would be considered.

4. Procedural Safeguards

A two-step approval process has also been introduced for application of the POEM Test. Before initiating proceedings for determine POEM for a foreign company, the assessing officer must seek the prior approval of the Principal Commissioner or Commissioner of Income Tax. Thereafter, in the event a finding that the foreign company has POEM in India, the approval of a three-member collegium would be required.[6] The Collegium may only take a decision after providing an opportunity to the taxpayer company to be heard.

IMPACT & ANALYSIS

While the Revised Guidelines provide clarity on certain points of concerns raised by the public, the overarching concern around subjectivity, in our view, still remains. That perhaps is an inherent feature of the POEM test which will remain unaddressed unless definite quantitative steps/criteria are provided for the tax payers.

Positive Clarifications

In case of a foreign company that is engaged in active business outside India and majority of board meetings are held outside India, POEM is presumed to be outside India. However, exception was carved out for cases where the board was considered to be 'standing aside' and not exercising its power of management. In response to concerns raised the Revised Guidelines have stated that following the global policies laid down by the parent with respect to administrative functions such as payroll, accounts, supply chains, etc., would not on its own constitute a case of the board standing aside standing aside so as to attract residence. This is a welcome clarification.

Clarity on the manner in which shareholder decisions on matters reserved for shareholder decision under the shareholders agreement or under the law while determining poem are also welcome, even if such clarifications are only limited.

The clarifications that (i) no ultimate subsidiary shall be regarded as having its POEM in India on the sole ground that the intermediate holding company has its POEM in India is also welcome, and (ii) the existence of a permanent establishment in India will not automatically result in POEM of a foreign company being in India, are both welcome clarifications.

The two-step approval process to be followed by the tax authorities while instituting proceedings to determine POEM would help in insulating companies further from notices that are based on flawed reasoning or frivolous in nature.

Additional Considerations and Concerns

The Revised Guidelines provided clarity on the terms used to classify a company as engaged in active business outside India. However, under its explanation for number of employees, it has also specified that 'employees' would include those person not employed directly by the company, but performing the same functions as that of an employee. This is a crucial point to be kept in mind, as it would mean that persons employed through independent contractors, etc. would also have to be accounted for the purpose of active business.

While the POEM test comes into effect from April 1, 2017 and will be applicable for all assessment years starting from AY 2017-18, in order to ascertain whether a company is engaged in active business outside India, the data for past 3 years is to be taken into account. This would mean that companies may be tested for POEM on the basis of assessment years already past, preventing them from organizing their business structure in light of this amendment. Considering that POEM is a yearly test, it may be practical more reasonable if the data pertaining only to the relevant year was considered.

The Revised Guidelines also appear to be contradictory at places where it is mentioned on the one hand that there can be only one POEM at any point in time but on the other hand if there is more than one POEM, one in India and one outside India, then it shall be presumed the POEM is in India if it has been mainly or predominantly in India. This is a cause of significant concern as there is no guidance on what would constitute as mainly or predominantly in India. Further, if a case of dual residence arises, it would be appropriate to allow the provisions under the Double Tax Avoidance Agreements deal with such situations, particularly with the impending implementation of the Multilateral Instrument that is set to address the particular issue of dual resident companies.

The Revised Guidelines also contain a number of guiding principles for the determination of POEM, some of which are carried over from the Draft Guidelines, but fail to provide any guidance on how these principles would work vis-a-vis with each other. Further, they also use ambiguous terms to define the weightage of each principle and the extent of its relevance for determination purposes. For example, it provides that the location where the Board regularly meets and makes decisions ***may be*** the POEM of the company. In cases where the Board delegates some or all authority to an executive committee consisting of key members, it is stated that the location where the members are based and where such committee develops the key strategies and policies for mere formal approval by the Board, ***will often be considered*** as POEM. They also state that the location of the company's head office will be a ***very important factor*** in the determination of POEM. The Revised Guidelines fail to clarify what instances constitute 'often', and how important a factor the head office is in comparison with the other factors. Such consistently ambiguous wording on applicability of factors shows that the POEM test is intended to be left open in scope, so that it is impossible for companies to predict whether their business would constitute a POEM in India. In such a circumstance an advance ruling mechanism may have been helpful for companies to determine their tax residence in advance and arrange their finances accordingly. However, since POEM has to be determined each year, it is unlikely any authority would be able to dispense with such rulings on a timely basis leaving the companies under a dark cloud of uncertainty each year.

Further, while the Revised Guidelines offer some clarity on what amounts to a 'key commercial or management decision', there is still ambiguity in distinguishing them from operational decisions, especially in relation to the veto powers exercised by majority shareholders as are often provided in shareholder agreements. The distinction available fails to cover the various possible decisions and instead demarcates the most extreme cases, leaving those forming the middle ground to be litigated in courts before arriving at a standard.

The CBDT still remains firm in its decision to adopt the POEM test, instead of seeking better suited alternatives for anti-avoidance, such as Controlled Foreign Corporation ("**CFC**") rules. CFC rules would be far more objective and predictable in comparison to POEM, as it would offer a non-exhaustive list of relevant factors to be considered. In a jurisdiction like India which is regarded as having an adversarial attitude and heavy on tax litigation towards taxpayers it would be wiser to adopt a simpler CFC regime similar to those adopted in advanced economies such as the USA.

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You can direct your queries or comments to the authors

1 Circular No.06 of 2017
2 The Explanation to Section 6(3) states that "place of effective management" means *a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.*
3 Some of the examples of such policy mentioned in the Revised Guidelines include policy relating to pay roll functions, supply chain functions, accounting, human resource functions, IT infrastructure and network platforms, routine banking operational procedures etc.
4 Passive Income includes income by way of (i) royalty, (ii) dividend, (iii) capital gains, (iv) interest or rental income (v) income from related party transactions.
5 The Revised Guidelines also contemplate scenarios where such control is exercised by any other person, including promoters or strategic, legal or financial advisors, followed by nothing more than routine ratification of decisions by the Board. Such scenarios, the Revised Guidelines state, would result in the determination of POEM at the place where the actual decisions are made.
6 This collegium shall be constituted by the Principal Chief Commissioner of the relevant region, and shall consist of three members who are Principal Commissioner or Commissioners.