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Date of Publishing: January 28, 2016

Draft POEM Guidelines - Analysis and Implications

VANDANA SHAH*

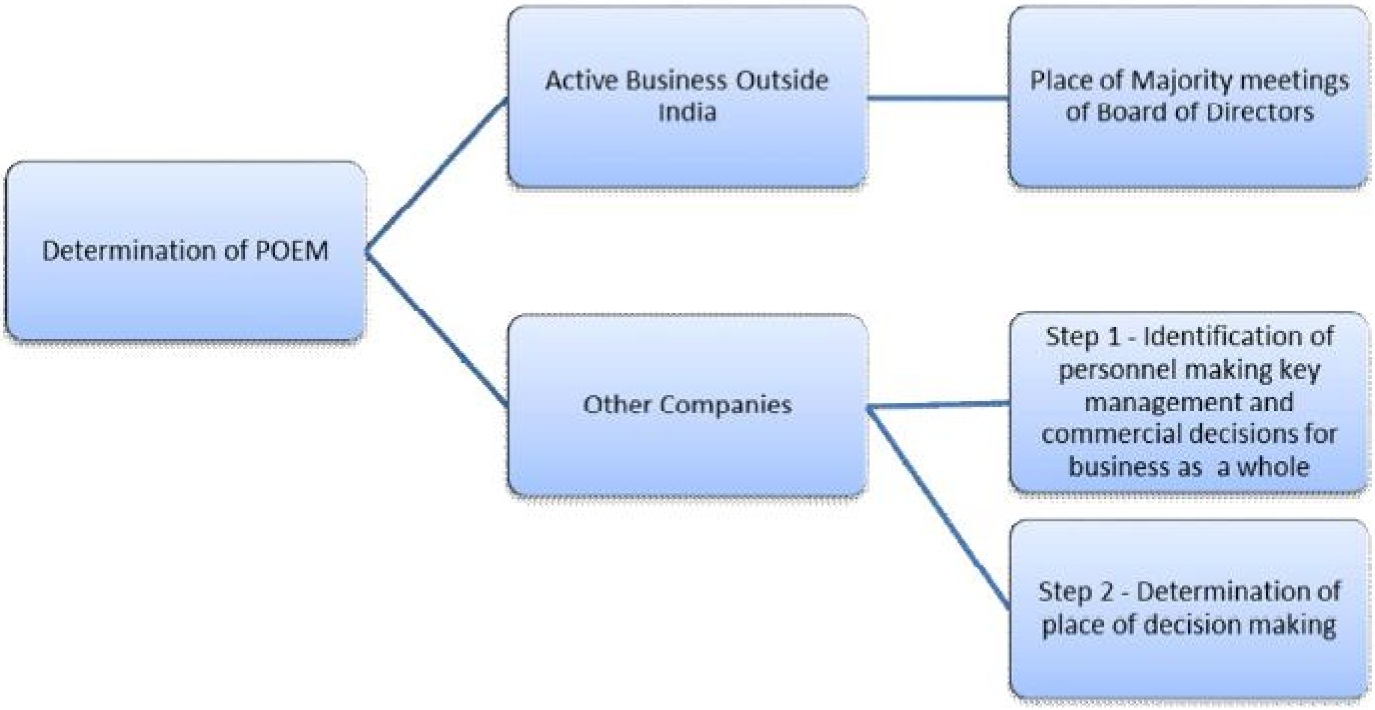
The rules dealing with corporate tax residency in India have been amended to provide that in addition to companies incorporated in India, a company shall be considered as a tax resident in India, if its place of effective management in that year, is in India.[1] The term "place of effective management" (POEM) has been defined to mean 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.[2]

The Central Board of Direct Taxes (CBDT) have recently issued draft guiding principles to be followed in the determination of POEM of a company by the taxpayers as well as the tax administration. The CBDT has invited comments and suggestions on the draft guidance.

This Article outlines the principles emanating from the draft guidelines currently issued by the CBDT, and discusses the related implications for foreign companies, including implications arising from an inter-play of POEM Rules with guidance provided by OECD[3] in various Final Reports on BEPS[4] Actions.

1. **Draft Guidelines for determination of POEM**

   The draft guidelines distinguish between companies having active business outside India and companies other than those engaged in active business outside India; and provide guidance for determination of POEM in both scenarios. The guidance is summarised below:



The determination of POEM in each of the above scenarios has been discussed in detail in subsequent paragraphs.

a. **Determination of POEM in cases involving active business outside India**

   A company has been defined to be engaged in active business outside India **if its passive income is not more than 50% of its total income** and **less than 50% of its total assets are situated in India**. Further, the company should have **less than 50% of total number of employees situated in India or resident in India** and **the payroll expenses incurred on such employees should be less than 50% of total payroll expenditure**.[5]

   The term "passive income" has been defined to mean the aggregate of (i) income from transactions where both the purchase and sale of goods is from/to its associated enterprises and (ii) income from royalty, dividend, capital gains, interest or rental income.

   While the POEM will depend upon the facts and circumstances of each case, in case of company engaged in active business outside India, the POEM shall be presumed to be outside India if the majority meetings of Board of Directors of the company are held outside India. However, for this purpose, the Board of Directors should actually exercise their management powers. In case such powers are being exercised by either holding company or any other person resident in India, then POEM will be considered to be situated in India.

b. **Determination of POEM in other cases**

   The guidelines provides for two stage process to determine POEM in case of companies other than those engaged in active business outside India - the first stage being identification or ascertaining persons who actually make the key management and commercial decision for conduct of company's business as a whole and the second stage being determining the place where these decisions are in fact being made.

   The guidelines provide that the place where company's Board regularly meets and makes decisions may be considered as company's POEM, if the Board actually exercises its authority to govern the company and in substance makes decisions necessary for the conduct of the company's business as a whole. Mere formal holding of Board meetings at a place by itself is not a conclusive factor for determination of POEM. If key decisions are in fact being taken at a place other than the place where formal meetings are held, then such other place would be relevant for determining POEM.

   Further, in cases involving delegating of authority, if the Board merely ratifies the key management and commercial decisions taken by senior management/other person including shareholder, then POEM will be the place where these senior manager or person make those decisions. Similarly, the location where members of executive committee are based and formulate key strategies and polices for mere formal approval by the Board may be considered as company's POEM.

The guidelines also emphasise the importance of company's head office since it often represents the place where key company decisions are made. If company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal's place of business, then that location is the place where head office is located. If the company is decentralised, having offices in various countries, then the company's head office would be the location where senior managers are predominantly based or normally return following travel to other locations or meet for formulation of key strategies and policies for the company as a whole. In situations involving participation in meetings via telephone or video conferencing, the head office would normally be at the location where the highest level of management and their direct support staff are located. Lastly, in situations where the senior management is so decentralised that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of company's head office would not be relevant for determination of POEM of a company.

In cases involving use of modern technology, the place where directors or persons taking decisions or majority of them usually reside may also be a relevant factor.

It is relevant to note that the place of management decision making is more relevant than the place of implementation of such decisions. Further, day to day routine operational decisions taken by junior and middle management shall not be relevant for the purpose of determination of POEM.

If the above factors do not lead to a clear identification of POEM, then, the guidelines provide for consideration of secondary factors such as place where main and substantial activity of company is carried out or place where accounting records of the company are kept.

c. **General Guidelines for determination of POEM**

   i. The guidelines provide that the POEM is considered to be situated at a place where key management and commercial decision for conduct of the company's business as a whole are undertaken.

      Accordingly, in case the decisions for business as a whole are taken in India and the decisions merely relating to specific activities/areas such as personnel, sales, purchase, etc. are taken abroad, in such cases, the POEM may be considered to be situated in India.

   ii. In the context of outbound investments, the guidelines provide relief to Directors of foreign company who reside in India but do not make key management and commercial decisions of the foreign company. In the context of inbound investments, the guidelines provide relief to foreign company having merely local management in India in relation to only the Indian operations of such foreign company, or merely having support functions in India.

   iii. The guidelines clarify that the principles outlined therein are for guidance only, and no single principle is decisive in itself. One needs to consider the activities performed over a period of time during the year and not with reference to any particular moment in time.

      This implies that the intention is to consider POEM in India only if activities continue in India for reasonable period of time and mere stray or solo decision making in India should normally not constitute POEM of foreign company in India.

2. **Indian POEM guidelines vis a vis OECD's BEPS Action Plans**

   a. Article 4 of OECD Model Tax Convention deals with the term " Residence" for the purpose of Double Tax Avoidance Agreement (DTAA). Article 4 provides that the dual resident person shall be deemed to be a resident only of the state in which its POEM is situated.

      It is relevant to note here that in the OECD's final report on **BEPS Action 6 - "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances**", OECD has suggested changes to OECD Model Tax Convention. The OECD has recommended that the Competent Authorities of the Contracting States shall endeavour to determine by mutual agreement, the residency of an entity, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.[6] Further, it also recommends that Competent Authorities would be expected to take account of various factors such as such as meeting of Board of Directors or equivalent body, place where 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 person's headquarters are located, which country's law govern the legal status of the person, where its accounting records are kept, whether there is a risk of improper use of the DTAA provisions if a person is considered as a tax resident of one country and not other; to be considered for determination of residency.[7] While the Indian guidance dealing with POEM is more or less on same lines specifically for passive companies, there are additional factors prescribed under OECD Commentary on Model Tax Convention to determine POEM.

Also, it is pertinent to note that once the rule regarding determination of residence by Competent Authority is included in DTAA, different set of rules will be prevalent under the DTAA and Indian domestic laws. This may involve litigation between taxpayers and tax authorities. For instance, in cases where foreign companies are deemed to be tax resident in India due to POEM rules in India, the foreign company may have recourse to DTAAs and by virtue of Article 4 of DTAA, may necessarily have to request for determination of tax residency by Competent Authority. The determination of residence by Competent Authority may be a time consuming and costly process for the taxpayers.

b. In cases involving transactions between associated enterprises, OECD's Final Report on **BEPS Actions 8-10 - "Aligning Transfer Pricing Outcomes with Value Creation"** requires consideration of actual control over functions, assets and risks, as evidenced by decision making authority and factual exercise of such authority. The interplay of the POEM and Transfer Pricing Rules would ensure that in case where senior management and control functions are present in India, a substantially high proportion of income of the MNE group will be taxed in India.

c. OECD's Final Report on **BEPS Action 13 - "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting"** requires country by country reporting by large MNE groups with regard to their assets, profits, economic activities, etc. This is expected to enable better risk assessment by tax authorities worldwide, by providing information about the global allocation of the MNE group's revenues, profits, taxes, and economic activity. There is currently no guidance provided by the CBDT as regards use of this information by Indian tax authorities. In case this information is shared with tax officers, it may lead to additional inquiries from the tax authorities from a POEM perspective.

3. Some other aspects that merit consideration:

a. The concept of effective management generally deals with the senior management and their decisions - not the place where operations of the entity are carried out. Even in the international context, much significance is generally attached to the actual management and control of the company rather than place of operations of business. However, the current guidelines create a distinction between active and passive business companies and also considers additional factors such as location of assets and employees to determine active business, and consequently, the POEM of a company.

b. Once a foreign company is considered as tax resident of India, the foreign company will be taxed in India on its global income in India and will have to comply with various provisions under the Indian Income Tax Act. For instance, there would be an obligation on the foreign company to file tax return, comply with maintenance of account and audit provisions, transfer pricing provisions, withholding tax provisions, etc. It may be possible that the foreign company may have to undertake compliance in respect of certain overseas transactions, which are not even related to India.

c. There is lack of clarity in relation to determination of POEM in triangular cases and the issue of foreign tax credit in case of dual taxation. To illustrate - Suppose a company "A" incorporated in

Singapore is considered to have a place of effective management in India and is receiving interest from Netherlands. In such cases, issue arises whether Singapore-Netherlands DTAA or India-Netherlands DTAA will be applicable for the purpose of determination of withholding taxes in Netherlands.[8] Another linked issue relates to the claim of foreign tax credit. Once the company is considered as Tax Resident in India, its global income will be taxable in India and the corresponding foreign tax credit will need to be claimed in India. The guidelines are currently silent on these aspects.

d. The requirement of determining the POEM is an annual exercise, and therefore, foreign companies will be required to evaluate their tax residence and associated tax implications in India on a year to year basis. This could also pose a serious practical challenge especially with respect to compliances towards the beginning of the year, when the foreign company would not know whether the POEM for the year would be situated in India or not.

e. The proposed[9] Controlled Foreign Corporation (CFC) regime intended to tax foreign companies controlled by Indian residents (qualifying as CFC) on fulfillment of certain specified conditions - one of them being that the foreign company should be tax resident of territory with lower rate of taxation. With the introduction of POEM and its related guidelines, foreign companies earning passive incomes and being effectively managed from India will be taxed in India even without the requirement of being based in lower tax rate jurisdiction.

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* Vandana Shah Charted Accountant

1. Prior to amendment, section 6 of the Income Tax Act (ITA) provided that a company shall be resident in India if during that year, the control and management of its affairs is situated wholly in India.

2. Reference section 6 of ITA

3. Organisation for Economic Cooperation and Development

4. Base Erosion and Profit Shifting

5. The average of data of the previous year and two preceding years would be considered to determine whether or not the company is engaged in the active business outside India. In case the company is in existence for shorter period, then such period would be considered.

6. Para 48 of BEPS Final Report on Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

7. Para 48 of BEPS Final Report on Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

8. The withholding tax provisions under the local tax laws of Netherlands have been ignored for the purpose of this example.

9. Proposed Direct Tax Code