

## Indian POEM – not so poetic! An analysis of India’s new place of effective management rules

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The Indian government, on January 24, 2017, released final guidelines for determining a foreign company’s place of effective management (“POEM”), which is India’s new test for corporate tax residence. The guidelines are relevant for financial year 2016–17 and future years.

Introduced in 2015, POEM has replaced India’s longstanding control and management test with a more ambiguous and subjective test, and will likely result in more foreign companies being considered Indian tax residents. This could lead to more frequent litigation on the issue of Indian corporate tax residence.

### India corporate residence

Historically, the criteria for corporate tax residence in India had been fairly objective and uncomplicated, being primarily based on the place of incorporation of the company.

Until 2015, the only manner in which a foreign company could be deemed to be an Indian tax resident was if the control and management of its affairs were “wholly” situated in India during the concerned financial year. Therefore, it was only in very rare cases that a foreign company was deemed an Indian tax resident.

The control and management test has stood the test of time in India since 1922 when it was introduced for the first time under Income Tax Act, 1922. Over the years, India had chosen to retain the control and management test despite the prevalence of more subjective tests used in other countries, such as the central control and management test<sup>[1]</sup> used in the UK and the place of effective management test in some parts of Europe. In fact, despite a review and amendment of the test of corporate residence in 1958, the control and management test survived<sup>[2]</sup> and was even continued into the Income Tax Act, 1961 (“ITA”).

It has been a settled position, through cases such as the 2007 decision in *Radha Rani Holdings (P.) Ltd. v. Director Income Tax*<sup>[3]</sup> that for a foreign company to be considered an Indian tax resident, its directors must exercise complete local control over it and not even a part of the control and management of the company should be situated outside India.

### POEM amendments

The Finance Act, 2015 amended Section 6(3) of the Income Tax Act, 1961 to provide that a foreign company would be deemed to be an Indian tax resident if, during the concerned financial year, its POEM is found to be in India, thereby replacing the control and management test.

The explanation to Section 6(3) defines POEM as “*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.*”

The idea of introducing the POEM test has been to align the domestic law on corporate residency with India’s double taxation avoidance agreements and with OECD’s Model Tax Convention, which rely on POEM as a tie-breaker test.<sup>[4]</sup>

The POEM test, when originally introduced, was intended to apply to financial year 2015–16. However, in light of extreme uncertainty and the inherent ambiguity associated with the POEM test, and in the absence of any guiding principles, explanations, or precedents for application of POEM in India, the government deferred its effective date by a year, i.e., to April 1, 2016.

### **POEM guidelines**

The new guidelines stress the concept of substance over form for the determination of POEM, which will be a yearly exercise considering that residence is required to be determined every year.

For the purpose of determining POEM, the guidelines place foreign companies into two categories: active foreign companies and passive foreign companies.

A foreign company qualifies as an active foreign company if all the following conditions are satisfied:

Passive income is less than 50% of its total income. Passive Income covers income from transactions where both the purchase and sale of goods is between related parties, as well as income from royalty, dividend, capital gains, interest, and rent. The guidelines provide a carve-out with respect to interest income of regulated banking companies and public financial institutions, which are not considered as passive income.

- Less than 50% of the value of the company’s total assets are situated in India.
- Less than 50% of the company’s employees are Indian residents. Employees include persons who perform tasks similar to those performed by employees, even though such persons are not directly employed by the company.
- Payroll expenses incurred on Indian resident employees are less than 50% of the company’s total payroll expenses.

A company that fails any of the above conditions is considered a passive foreign company.

### **Active foreign company**

An active foreign company is given a benefit of presumption that its POEM is outside India if a majority of its board meetings are held outside India, unless it is established that its board is standing aside and not exercising its powers of management and such powers are being exercised by some other person resident in India.

The language in the guidelines suggests that if a company can objectively satisfy that it is an active foreign company, and a majority of its board meetings are held outside India, the burden to establish that its board is ‘standing aside’ falls on the Revenue.

It is clarified that merely because a company's board follows general and objective principles of global policy of its group, laid down by the company's parent with respect to administrative functions, such as payroll, supply chains, etc., does not by itself result in the board being considered as 'standing aside.'

### **Passive foreign companies**

For passive foreign companies, the determination of POEM is a two stage process. The first step is to identify persons who are making key management and commercial decisions of the company's business as a whole, followed by a determination of where these decisions are in fact being made (and not implemented).

### **Guiding principles for determination of POEM**

The guidelines provide general guiding principles which should be considered in determining the POEM of a company. Broadly, these are broadly laid down below.

#### *Location of board meeting*

The location where the board of the company regularly meets and makes decisions for the company may be construed as the POEM, provided that the board retains its authority to govern the company and itself takes key management and commercial decisions, i.e., such authority is not de facto delegated by the board to someone else.

This is a grey criterion where there are several riders involved in presuming POEM at the place where board meetings are held, thereby leaving sufficient room for enquiry for the authorities. Further, it hasn't been conclusively stated whether the minutes of the board meeting recording the location to be outside India is sufficient to establish that it was undertaken outside India.

This could possibly raise concerns regarding whether the Revenue is empowered to also examine factors, such as flight tickets or passports of Indian resident directors of the foreign company, despite the board minutes recording the location of the meeting as being overseas.

#### *Board delegation to committee, head office location*

If the board (de facto or de jure) delegates some of its authority to a committee consisting of key members of senior management, the location where such members are based, and where the committee formulates and develops key strategies and policies for mere formal approval by the board will often be considered to be the company's POEM.

The guidelines define 'senior management' as persons who are generally responsible for formulating key strategies and policies of the company and overseeing their implementation on an ongoing basis. These persons may include managing director or CEO, financial director or CFO, chief operating officer, and heads of various divisions or departments.

#### *Location of head office*

The location of the head office is considered an important factor in determining POEM, and is to be determined considering factors such as:

- Location where the company's senior management and support staff are based and which is held out to the public as its headquarters.
- In case of a more decentralised company, the place where the senior management is predominantly based, normally returns to after travel, or meets when formulating key strategies or policies would be considered the head office.
- Where 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 will be considered as the head office.
- In case of a highly decentralized company where it is not possible to determine location of head office, the head office would not be of much relevance in determining POEM.

#### *Physical location of meetings not relevant*

Emphasizing on the role of modern technology, the guidelines also attribute significance to the place of residence of majority of the directors or persons making the decisions for determination of POEM in cases where physical location of board meetings or executive committee meetings is not the place where the key decisions are actually made.

#### *Decisions through circular resolutions*

The guidelines provide the necessary clarification in cases where directors are in separate locations and decisions are taken through circular resolutions.

The new guidelines further state that the location of the person proposing the decisions would not by itself be sufficient to determine POEM. The location of persons who exercise the authority to make decisions, the type of decisions, and the frequency of circular resolutions will also be relevant factors.

#### *Non-relevant factors*

The POEM guidelines also confirm that the following factors, by themselves will not trigger a POEM risk: the fact that shares of a foreign company are entirely held by an Indian company, that some directors of the foreign company are Indian residents, that the local management of foreign company in respect of Indian activities or support functions of preparatory or auxiliary character is situated in India, and the fact that a foreign company has a permanent establishment in India.

#### *POEM and shareholder decisions*

Another welcome clarification in the guidelines is that POEM is not concerned with decisions on matters statutorily reserved for shareholders.

These typically include decisions associated with existence of the company itself or rights of shareholders, such as sale of substantially all assets of the company, liquidation or deregistration of the company, modification of shareholder rights or issuance of new shares, etc.

Having said that, this clarification does not extend to cases where, through a shareholder's agreement or otherwise, the involvement of shareholders turns to effective management of the company in situations such as where shareholders limit the authority of the company's board or senior management to take decisions.

### *Routine operations*

Routine operational decisions, i.e., decisions relating to oversight of day-to-day operations and activities of the company taken by junior or middle level management are not relevant for the purpose of POEM, the guidance states.

POEM is only concerned with key management and commercial decisions at a broader strategic and policy level, such as a decision relating to opening of a new manufacturing facility or discontinuing a major product line.

As opposed to these, decisions by the plant manager appointed by the senior management concerning repair and maintenance, implementation of quality controls and human resources policies would be routine operational decisions.

If none of the above guiding principles lead to clear identification of POEM, the secondary factors to be considered are the place where main and substantial activity of the company is carried out or the place where the accounting records are kept.

### **Invoking POEM**

The guidelines prescribe that Revenue undertake a two-step approval process to initiate a POEM challenge.

The assessing officer is required to obtain a prior approval of the jurisdictional Principal Commissioner or Commissioner of Income Tax, as the case may be.

Further, if the assessing officer arrives at a finding that the company's POEM is in India, such finding must be approved by a collegium of three Revenue officials, and the concerned company must be given an opportunity of being heard by the collegium.

### **Vague principles**

While the guidelines provide several principles for the determination of POEM, there is a lack of clarity in the guidelines regarding the interplay of these principles vis-à-vis each other. The language used is fraught with ambiguity and the weightage of these principles on the determination of POEM has been left open ended and vague, with terminologies like 'may be the company's POEM,' 'would be relevant for POEM,' 'will often be considered to be the company's POEM,' etc. There is also no order of precedence amongst the guiding principles or a minimum threshold combination of factors to trigger POEM.

Therefore, for a foreign company organizing its business structure in light of POEM, the guidelines do not provide much certainty to predict whether its business would constitute POEM in India, and could at best act as a set of indicative principles. While obtaining an advance ruling may be desirable, since determination of POEM is a yearly exercise, it is unlikely that the government's Authority of Advance Rulings will be able to keep pace with such a yearly determination, leaving the companies under a cloud of uncertainty.

### **POEM incompatibility with ITA**

With the shift from a ‘control and management’ test to the POEM test of corporate residence, it is a lot more likely that foreign companies will be considered Indian tax residents. However, other provisions of the ITA do not seem to contemplate foreign companies which are Indian tax residents by virtue of POEM, and therefore their application to such companies may have unintended consequences resulting in undue hardship to these companies including multiple layers of taxation.

As an example, under the ITA, dividends paid by a ‘domestic company’<sup>[5]</sup> are subject to a dividend distribution tax which is to be borne by the company over and above the corporate income tax payable on its profits.<sup>[6]</sup> These dividends are exempt in the hands of shareholders<sup>[7]</sup>, except where the shareholder is an individual, limited liability partnership, partnership firm, or Hindu Undivided Family receiving dividends in excess of INR 1 million (approx. USD 15,000) from domestic companies, in which case an additional 10% tax is applicable in the hands of such persons. This results in a triple economic taxation on the same income stream, i.e., in addition to corporate tax and dividend distribution tax payable by the distributing company.

Recently, Finance Bill, 2017 has proposed to extend this tax to all persons resident in India other than domestic companies and certain funds, institutions, trusts, universities, etc. established for charitable, religious, or educational purposes.

Since the carve out under the proposed amendment is limited specifically to ‘domestic companies,’ this tax could also cover dividends received by a foreign company which is deemed to be an Indian tax resident by virtue of having its POEM in India, thereby resulting in undue hardship for such a company.

Further, dividends further up-streamed by the foreign company could additionally be taxed at normal tax rates in the hands of the Indian promoters, i.e., at slab rates for individuals and at 30% for Indian companies or LLPs (except in case of Indian companies holding more than 26% of the nominal value of shareholding of the foreign company, where the rate of tax is 15%<sup>[8]</sup>).<sup>[9]</sup> This could potentially impact externalization structures, for instance, in the information technology space where India-based promoters establish foreign companies which in turn may have Indian subsidiaries for product development or R&D.

Hence, due to incompatibility of the ITA provisions with the POEM test, dividends finally received by the Indian subsidiaries could potentially be subject to an economic quadruple taxation!

### **Lack of independence in procedural safeguards**

While a procedural safeguard in respect of POEM is comforting, both stages of the approval process lie with higher level Revenue authorities, which more often than not confirm to the findings of lower level authorities.

This is evident from some of the experiences under the ITA, for instance in the case of India’s Dispute Resolution Panel, which is set up as an alternate appeal mechanism for non-resident taxpayers (and domestic taxpayers involved in transfer pricing disputes) under Section 144C of the ITA.

The panel consists of three revenue officials and is criticized for rarely taking a position contrary to the AO.<sup>[10]</sup> On the contrary, necessary safeguards have been provided for invocation of General Anti-avoidance Rules (also slated to come into force on April 1) to an arrangement, where the approving panel is chaired by an existing or former High Court judge, accompanied by one Revenue official, and an academic or scholar. A similar independent approval process for POEM would have been desirable.

### **POEM & tax treaties**

While POEM as a concept of corporate residence aligns with the tie-breaker test in most of India's tax treaties, the possibility of the other country not accepting India's determination of a company's POEM cannot be ruled out.

This is because classification of companies based on active and passive income is not usually associated with corporate residency but with anti-abuse measures, such as controlled foreign company rules.

Further, Indian Revenue's large appetite for tax litigation in comparison to its global peers may result in an unusually large number of foreign companies being deemed Indian tax residents. This inconsistency may result in a double taxation risk for the foreign company if it is considered as a tax resident of India by virtue of POEM and a tax resident of its home jurisdiction under the tie-breaker test of POEM under the relevant tax treaty.

The risk of double taxation is especially pronounced in situations where US companies are founded or held by Indian promoters since the India-USA tax treaty does not recognize the concept of POEM and renders companies which are a tax resident of both countries outside the scope of the treaty.

## **Conclusion**

Determination of tax residence is the first step towards determining tax incidence and therefore should be free from any ambiguity or uncertainty.

Introduction of POEM in India appears to be a step backwards from the settled law of 'control and management' which has led to minimal litigation for the almost 100 years of its existence.

It is worth pondering whether India should have taken a leaf out of USA's book and maintained an objective test, such as incorporation, for determining corporate residence, and instead introduced an anti-abuse measure, such as controlled foreign company rules, to counter abusive externalization arrangements.

Further, the test of active and passive income is globally associated with controlled foreign corporation rules and is not consistent with a corporate residency test, revealing India's intent to introduce an anti-abuse measure in the garb of a corporate residency test.

Lastly, as discussed above, the guidelines, though introduced as a measure to provide clarity, contain a lot of unironed creases, and only enhance the inherent ambiguity in the new

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[1] In the UK, a foreign incorporated company is considered a tax resident of UK if its central control and management is in UK. This test was first laid down by the House of Lords in *De Beers Consolidated Mines Limited v. Howe* [1906 A 455], and is generally understood to mean the place where the management decisions are made.

[2] Before the amendment by Finance Act, 1958, besides the control and management test, the Income Tax Act, 1922 deemed a foreign incorporated company as an Indian tax resident even if its Indian income exceeded its foreign income. However, Finance Act, 1958 omitted the latter test pursuant to a recommendation by the Law Commission and retained control and management test as the sole test for deeming foreign companies as Indian tax residents. [please see Law Commission of India, Twelfth Report; Available at <http://lawcommissionofindia.nic.in/1-50/report12.pdf>]

[3] (2007) 110 TTJ (Del)

[4] Article 4(3) of the OECD's Model Tax Convention states that "a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated."

[5] Defined in Section 2(22A) of the ITA as an Indian incorporated company or any other company which has made arrangements for declaration and payment of dividends in India out of income liable to tax in India.

[6] Section 115O of the ITA

[7] Section 10(34) of the ITA

[8] Section 115BBD of the ITA

[9] This is because dividends are exempt in the hands of shareholders only in cases where the distributing company has suffered a DDT under Section 115-O of the ITA, which is levied only on 'domestic companies'. Therefore, dividends received from a foreign company which is a tax resident by virtue of POEM should be taxable at usual rates.

[10] Tax Administration Reform in India: Spirit, Purpose and Empowerment-TARC Reports of the Tax Administration Reform Commission, Ministry of Finance, Government of India. Page 246; available at [http://www.finmin.nic.in/the\\_ministry/dept\\_revenue/First\\_report\\_TARC.pdf](http://www.finmin.nic.in/the_ministry/dept_revenue/First_report_TARC.pdf)



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