



All India Chartered Accountants' Society  
&  
CFO WORLD



# Income Tax Expert Study Group

Meeting 4 (12<sup>th</sup> May 2018)

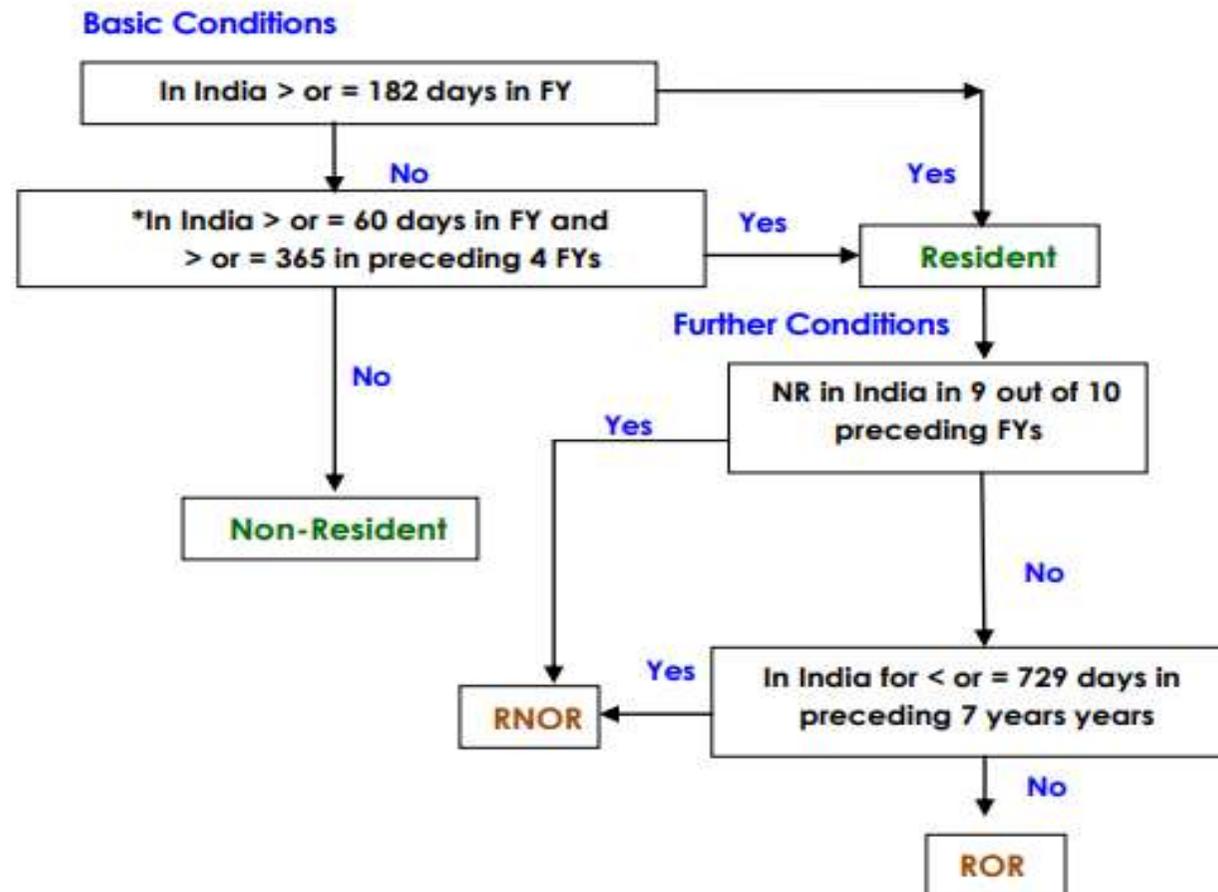


**AICAS INCOME TAX EXPERT STUDY**  
**GROUP**

12 MAY, 2018

# Key Issues of Residential Status (Section 6)

- Section 6 of the Income tax Act, 1961 provide for conditions in which residence in India is determined in case of different category of persons.
- Section 6 (1) deal with *the conditions to be satisfied for individuals to be treated as resident in India*. Following is the flowchart indicating the conditions:



## Key Issues of Residential Status (Section 6)

- As per section 6(3) of the IT Act, a company is said to be resident in India in any previous year if:
  - If it is incorporated in India; or
  - The control and management of its affairs is situated wholly in India.

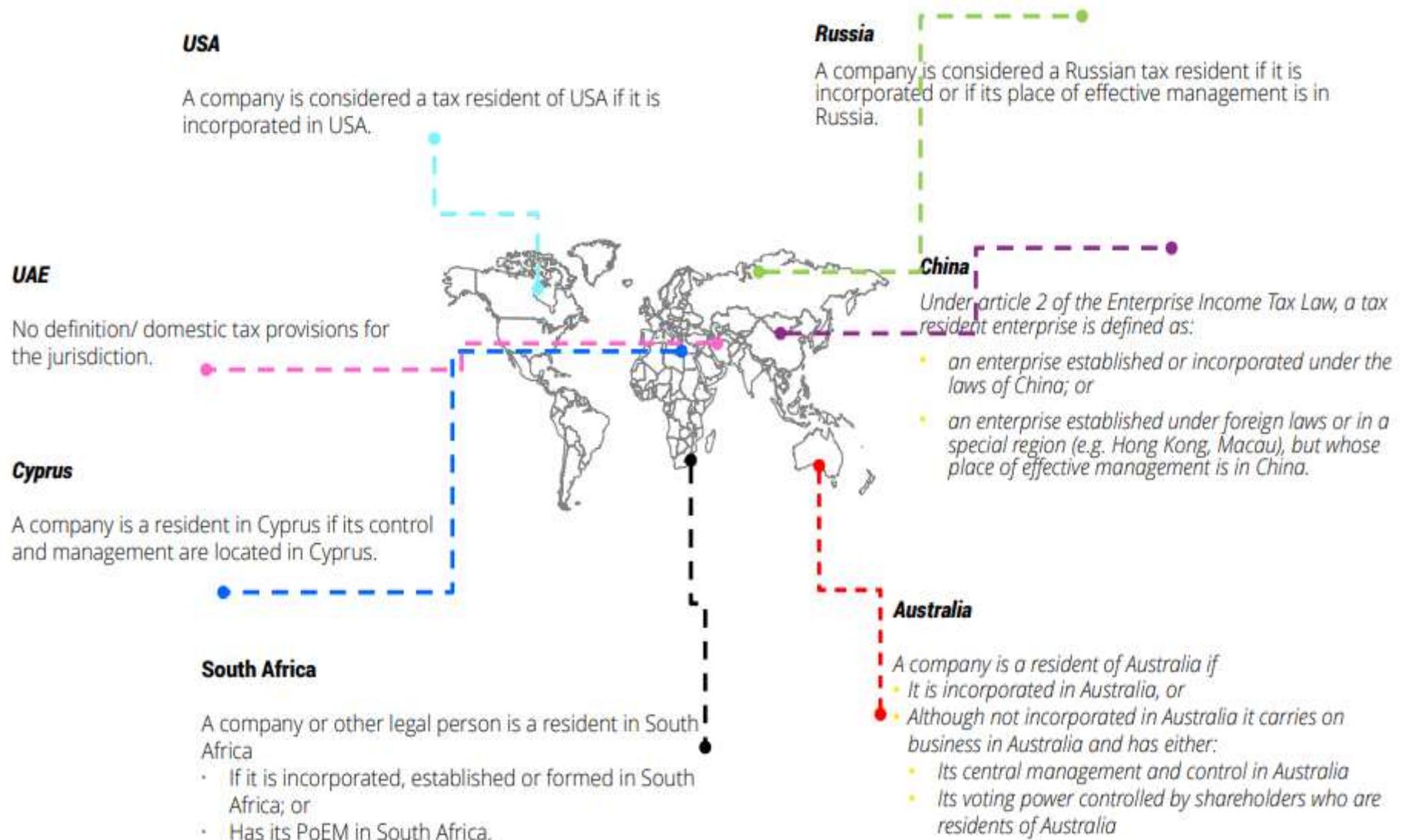
*(Prior to amendment to section 6)*

- Post Amendment to section 6 of the IT Act, a company is said to be resident in India in any previous year if:
  - The company is incorporated in India; (or)
  - Place of effective management, during that year is in India.

## Place of Effective Management (PoEM)

- W.e.f. 01<sup>st</sup> April 2016, the residential status of companies which are not incorporated under the corporate laws of India, would be determined by the concept of **“Place of Effective Management”**.
- PoEM has been defined in explanation to section 6(3) to mean:
  - A place where **key** management and commercial decisions that are **necessary** for the **overall conduct** of business
  - Of **entity as a whole** are in **substance** made

# Place of Effective Management (POEM) Tax Residency – Overseas Jurisdictions



# Concept of PoEM – Other Countries

## A brief overview of some of the general principles

- Countries across the globe in the past have considered PoEM as a method to determine residential status in their jurisdictions. However, there is no comprehensive guidelines issued for the above purpose and the same is based on satisfaction of certain general principles as laid down below:

Country	PoEM Understanding
Russia	Place where majority of BoD usually meet, place of senior management controlling day to day operations are located
Netherlands	Place where majority of BoD usually meet, location of HO, place where books of accounts are prepared, place where majority of the assets are located
South Africa	Place where majority of BoD usually meet, location of HO, place of controlling shareholder, place of senior management responsible for controlling day to day operations are situated
China	Place where senior management controlling day to day operations are situated, place of residence of management, place where majority of assets are located
Germany	Place where senior management controlling day to day operations are situated
United Kingdom	Place where majority of BoD usually meet
Australia	Place where majority of BoD usually meet, place of decision making of controlling shareholder
Singapore	Place where majority of BoD usually meet, place where senior management controlling day to day operations are situated

# Place of Effective Management Concept and Meaning

Based on a brief reading of the explanation to section 6(3) of the IT Act and the clarification points mentioned in the OECD commentary, the following factors may be considered as relevant in determining the trigger of tax residency in India.

- **Management:** For every organization, the management (i.e. the board of directors) or the key management personnel which effectively manage the key business functions of the company on a day to day basis. (i.e. decisions relating to strategy, finance, personnel etc.). Therefore, in the context of PoEM, it is necessary that the situs of the management is a key indicator as to the place from which the company is being managed.
- **Key commercial decisions:** The management (i.e. the board of directors) or the key management personnel is considered as the driving force of any company. The board of directors are primarily involved in formulating key business strategies and any other decision which would have a direct impact on the performance of the company or the primary objective of the company.

# Place of Effective Management Concept and Meaning

- **Day to day business functions:** Prior to the amendment to section 6(3) of the IT Act, emphasis was laid on control and management of the foreign company while determining the residential status for tax purposes. In this regard, various judicial authorities have also held that the control and management did not mean the day to day business functions of the company. Given the change in law, the place where the business is “effectively managed” i.e. where the key decisions which are necessary for the conduct of the business , this would be a critical factor in determining the residential status of a foreign company in India.
- **Other relevant factors:**
  - The concept of PoEM focuses on the significant importance of the situs of decision making body **BOD** or **the key person**, or any other body comparable to the board of directors which makes key decisions for the entity’s business **as a whole**.
  - The local corporate law, charter documents, shareholders agreement etc. will be relevant in determining where the ‘head and brain’ and hence where the PoEM of the company is.
  - However, as stated in the explanatory memorandum to the Finance Act 2015, PoEM is an internationally recognized concept and is also a fact based exercise.
  - In the ensuing slides, we have summarized the guiding principles for determination of PoEM issued by CBDT vide circular dated 24 January 2017.

# Place of Effective Management - Budget Speech

*“Further, it is proposed to define the place of effective management 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.*

*Since POEM is an internationally well accepted concept, there are well recognised guiding principles for determination of POEM although it is a fact dependent exercise. However, it is proposed that in due course, a set of guiding principles to be followed in determination of POEM would be issued for the benefit of the taxpayers as well as, tax administration.*

*These amendments will take effect from 1st April, 2016 and will, accordingly, apply in relation to the assessment year 2016-17 and subsequent assessment years.”*

## Guiding Principles for determination of PoEM of a Company.

- The amended provision would now be effective from 1<sup>st</sup> April 2017 and will apply to Assessment Year 2017-18 and subsequent assessment years.
- [\*\*Circular 8/2017 dated February 23, 2017\*\*](#) issued by CBDT has clarified that the provisions of PoEM will not be applicable to a Company having turnover of Rs. 50 crores or less in a financial year.

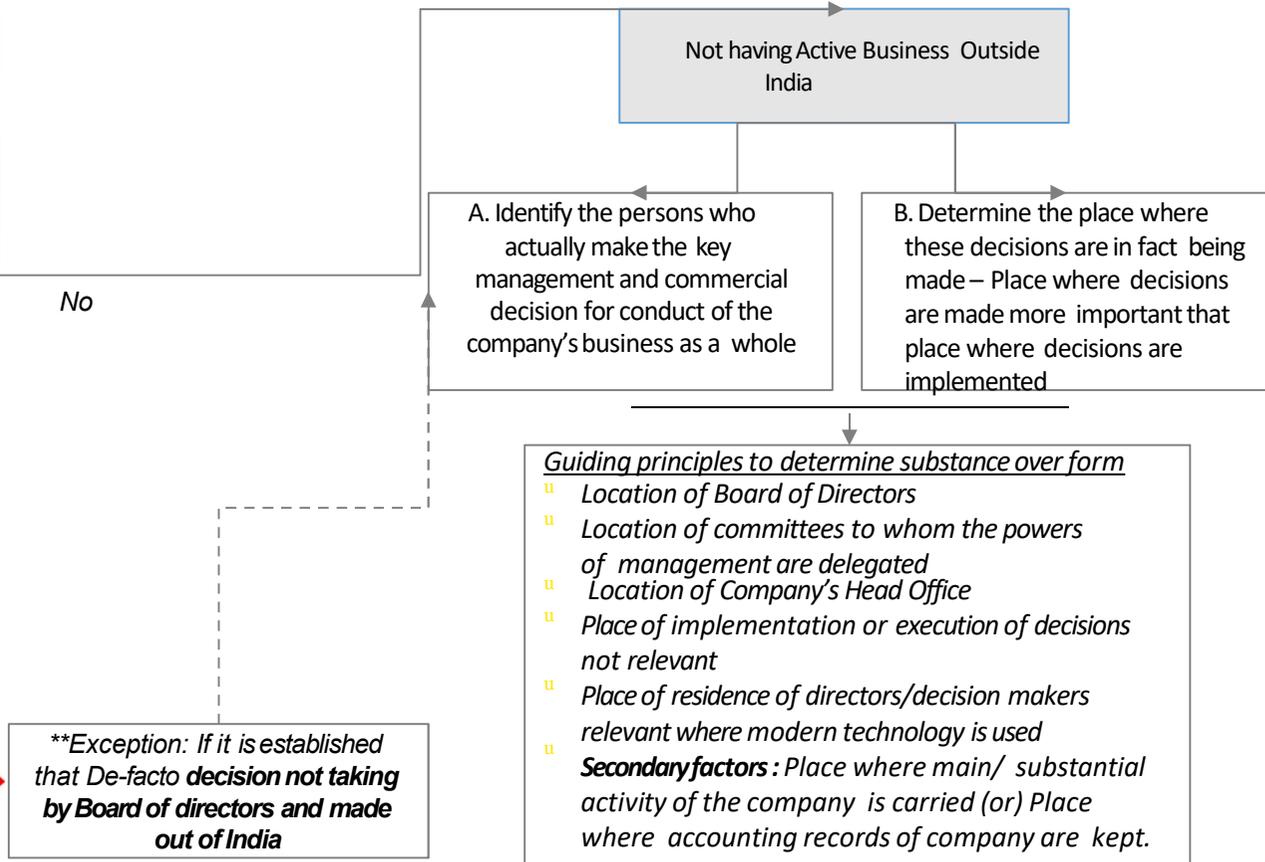
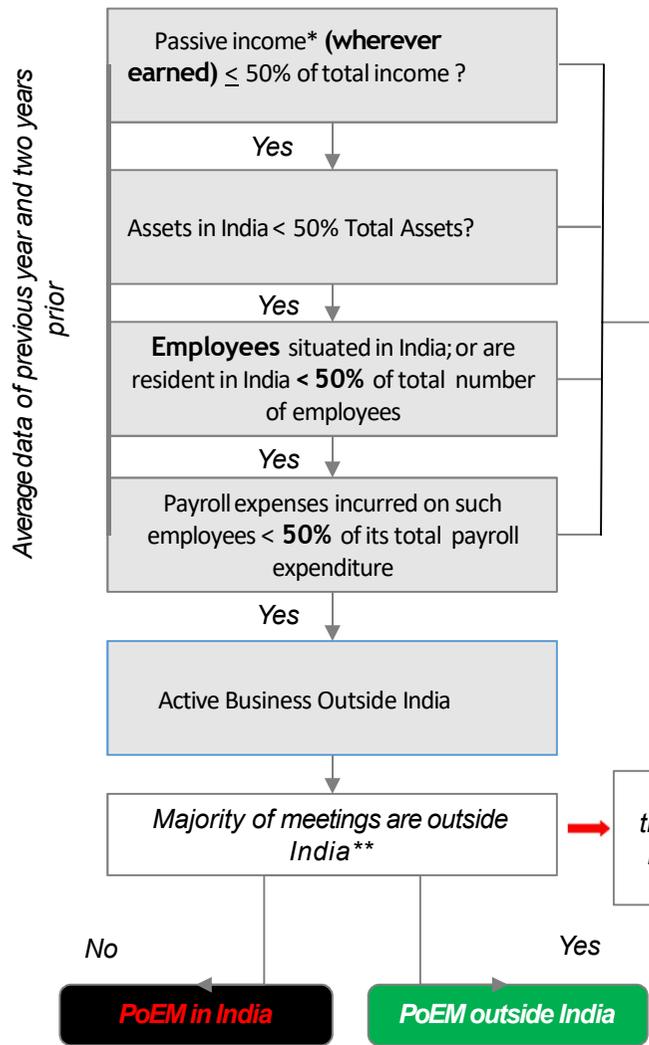
# Guiding Principles for determination of PoEM of a Company.

- Key changes to the guiding principles are summarised as follows:
  - Any determination of the PoEM will depend upon the facts and circumstances of a given case. The PoEM concept is one of **substance over form**.
  - Since “residence” is to be determined for each year, PoEM will also be required to be determined on year to year basis.
  - The process of determination of PoEM would be primarily based on the fact as to whether or not the company is engaged in **Active Business Outside India** .
  - The principles for determining PoEM are not to be seen with reference to any particular moment in time, rather the activities performed over a period of time, during the previous year, need to be considered. In other words a “snapshot” approach is not to be adopted.
  - Further, where 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 /predominantly in India.
  - The approach suggested in the draft guiding principles are for guidance only and no single principle can be considered to be decisive.

*In the subsequent slide, we have provided in brief the basis for determination of PoEM based on criteria laid down under the draft guiding principles.*

\* **Passive income** shall be aggregate of:  
 (i) Income from the transactions where both the purchase and sale of goods is from/ to its AEs  
 (ii) Income by way of royalty, dividend, capital gains, interest or rental income

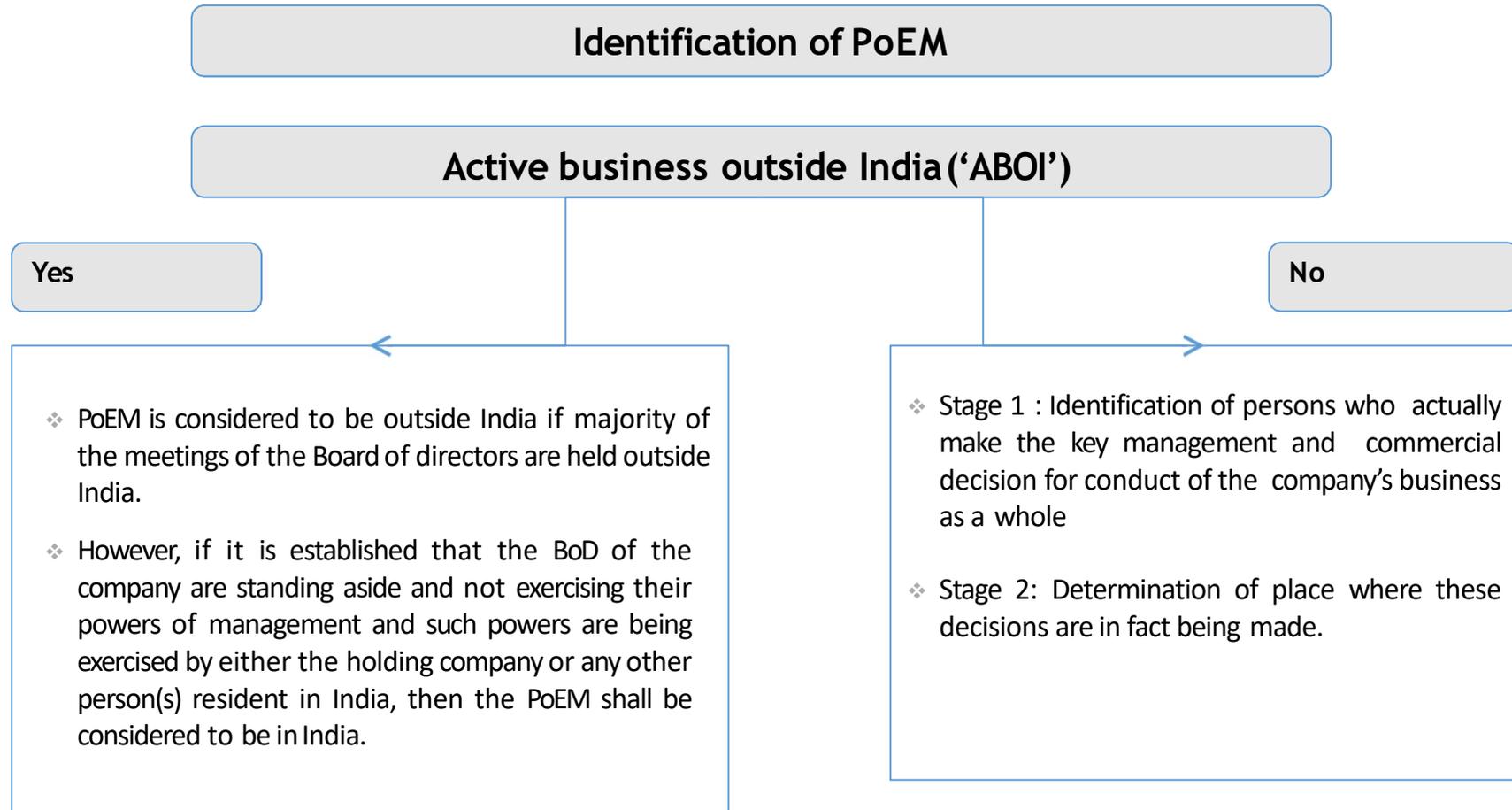
# Determining PoEM Guiding principles – Step Chart



**\*\*Exception: If it is established that De-facto decision not taking by Board of directors and made out of India**



# Determining PoEM Guiding principles – At a glance



# Determining PoEM Active Business Outside India test

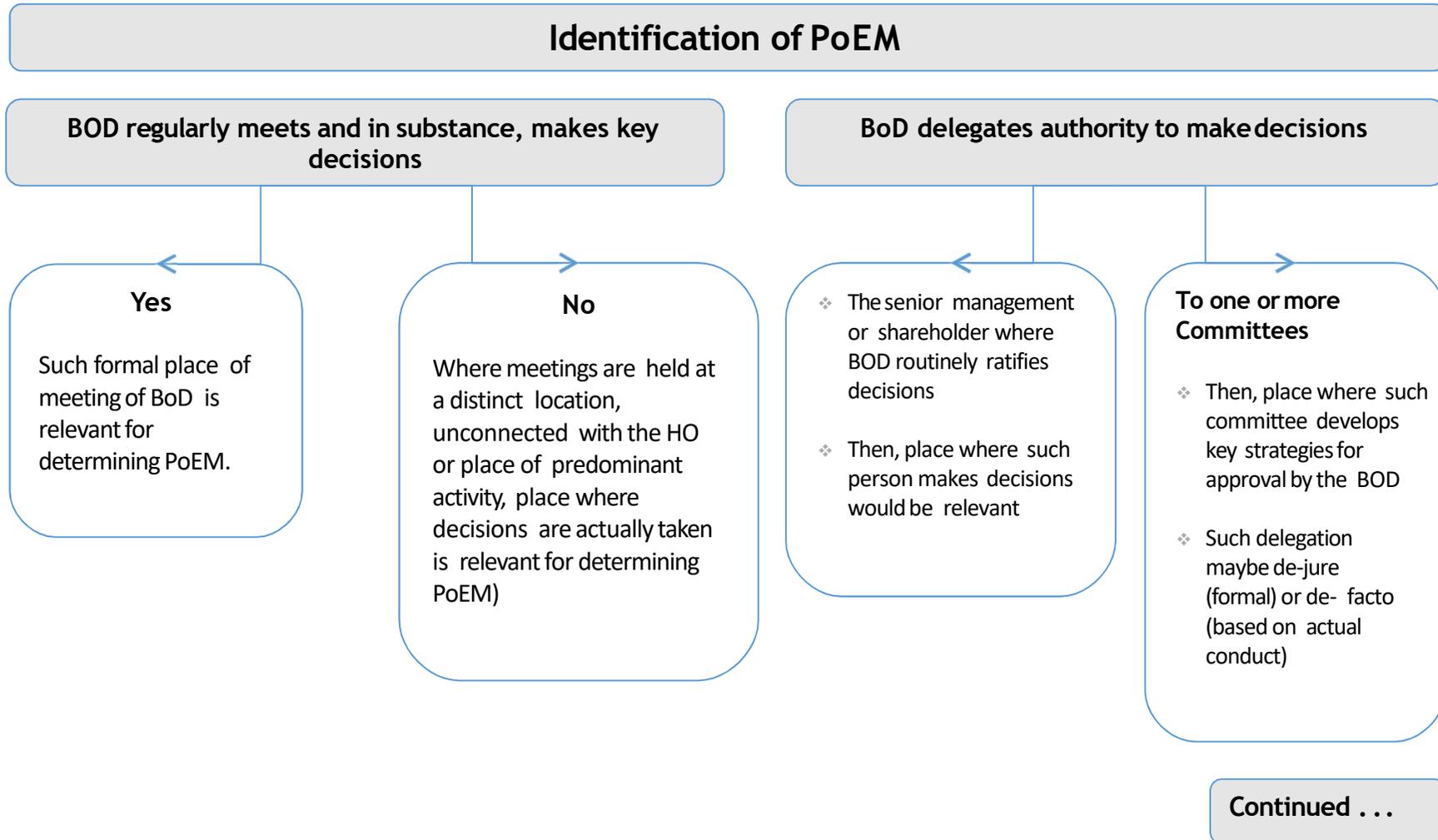
A company is said to be engaged in ABOI if it fulfils the cumulative conditions of:

- Its passive income (wherever earned) is 50% or less of its total income; and
- In respect of each of the following:
  - Less than 50% of its total assets are situated in India,
  - Less than 50% of total number of employees situated in India or residents in India; and
  - The Payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

***Passive Income of a company shall be aggregate of:***

- a. Income from the transactions where **both**, the purchase and sale of goods, is from or to its AEs
- b. Income, by way of royalty, dividend, capital gains, interest or rental income.

# Determining PoEM Flow chart – Not satisfying ABOI test



# Determining PoEM Flow chart – Not satisfying ABOI test

... Continued

## Identification of PoEM

### Company's HO

#### Single Location -

- ❖ Place where senior management and direct support staff are located.

#### Multiple Locations:

- ❖ Where senior management are predominantly based

#### Decentralized

- ❖ Not possible to determine PoEM – HO not relevant

### Advent of Modern Technology

- ❖ Physical presence of persons may not be required.
- ❖ Place where directors / decision makers usually reside

### Secondary factors

*(if the earlier do not lead to clear identification of PoEM)*

- ❖ Place where main/substantial activity of the company is carried
- ❖ Place where accounting records of company are kept.

# Guiding Principles for determination of POEM (contd.)

- **Other important considerations:**

It needs to be emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

- The fact that a **foreign company is completely owned by an Indian company** will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- The fact that there exists a **Permanent Establishment of a foreign entity in India** would itself not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- The fact that one or some of the **Directors of a foreign company reside in India** will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- The fact of, **local management being situated in India** in respect of activities carried out by a foreign company in India will not , by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.
- The existence in India of **support functions** that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

# ILLUSTRATIONS

## Example 1:

Company A Co. is a sourcing entity, for an Indian multinational group, incorporated in country X and is 100% subsidiary of Indian company (B Co.). The warehouses and stock in them are the only assets of the company and are located in country X. All the employees of the company are also in country X. The average income wise breakup of the company's total income for three years is, -

- (i). 30% of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises;
- (ii). 30% of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises;
- (iii). 30% of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises; and
- (iv). 10% of the income is by way of interest.

**Interpretation:** In this case passive income is 40% of the total income of the company. The passive income consists of, -

- (i). 30% income from the transaction where both purchase and sale is from/to associated enterprises; and
- (ii). 10% income from interest.

The A Co. satisfies the first requirement of the test of active business outside India. Since no assets or employees of A Co. are in India the other requirements of the test is also satisfied. Therefore company is engaged in active business outside India.

# ILLUSTRATIONS

## **Example 2:**

The other facts remain same as that in Example 1 with the variation that A Co. has a total of 50 employees. 47 employees, managing the warehouse, storekeeping and accounts of the company, are located in country X. The Managing Director (MD), Chief Executive Officer (CEO) and sales head are resident in India. The total annual payroll expenditure on these 50 employees is of Rs. 5 crore. The annual payroll expenditure in respect of MD, CEO and sales head is of Rs. 3 crore.

**Interpretation:** Although the first limb of active business test is satisfied by A Co. as only 40% of its total income is passive in nature. Further, more than 50% of the employees are also situated outside India. All the assets are situated outside India. However, the payroll expenditure in respect of the MD, the CEO and the sales head being employees resident in India exceeds 50% of the total payroll expenditure. Therefore, A Co. is not engaged in active business outside India.

# ILLUSTRATIONS

## **Example 3:**

The basic facts are same as in Example 1. Further facts are that all the directors of the A Co. are Indian residents. During the relevant previous year 5 meetings of the Board of Directors is held of which two were held in India and 3 outside India with two in country X and one in country Y.

**Interpretation:** The A Co. is engaged in active business outside India as the facts indicated in Example 1 establish. The majority of board meetings have been held outside India. Therefore, the POEM of A Co. shall be presumed to be outside India.

# ILLUSTRATIONS

## **Example 4:**

The facts are same as in Example 3 but it is established by the Assessing Officer that although A Co.'s senior management team signs all the contracts, for all the contracts above Rs. 10 lakh the A Co. must submit its recommendation to B Co. and B Co. makes the decision whether or not the contract may be accepted. It is also seen that during the previous year more than 99% of the contracts are above Rs. 10 lakh and over past years also the same trend in respect of value contribution of contracts above Rs. 10 lakh is seen.

**Interpretation:** These facts suggest that the effective management of the A Co. may have been usurped by the parent company B Co. Therefore, POEM of A Co. may in such cases be not presumed to be outside India even though A Co. is engaged in active business outside India and majority of board meeting are held outside India.

# ILLUSTRATIONS

## **Example 5:**

An Indian multinational group has a local holding company A Co. in country X. The A Co. also has 100% downstream subsidiaries B Co. and C Co. in country X and D Co. in country Y. The A Co. has income only by way of dividend and interest from investments made in its subsidiaries. The Place of Effective Management of A Co. is in India and is exercised by ultimate parent company of the group. The subsidiaries B, C and D are engaged in active business outside India. The meetings of Board of Director of B Co., C Co. and D Co. are held in country X and Y respectively.

**Interpretation:** Merely because the POEM of an intermediate holding company is in India the POEM of its subsidiaries shall not be taken to be in India. Each subsidiary has to be examined separately. As indicated in the facts since cos. B,C,D are independently engaged in active business outside India and majority of board meetings are also held outside India, the poem of these companies will be outside India

## Place of Effective Management Consequence of PoEM being in India

Tax consequences may vary considerably depending on the tax residence. In the context of the IT Act, an overseas company which is a resident will trigger tax implications/ obligations as are applicable to a resident company. The following consequences apply to a resident company, i.e. a foreign company which triggers PoEM in India

### Consequences

A resident company **pays tax in India on its global income** regardless of the Situs of accrual or receipt of income. Where the foreign subsidiary's PoEM is considered to be in India, the entire profits of the Company would be chargeable to tax in India at the rate of 40 percent plus applicable cess and surcharge.

Attracting **withholding obligation** as applicable to residents – say in respect of transactions with other residents and non-residents. Transactions between a resident and non-resident associated enterprise should be subject to **Indian transfer pricing regulations**. Also, once the entity is regarded as resident, it may trigger applicability of specified domestic transactions under section 92BA of the IT Act. Difficulty in maintaining documentation, report filing etc., may arise if residency change is alleged during the course of assessment.

## Place of Effective Management Consequence of PoEM being in India

If such foreign company pays taxes on its global income in both the countries. It may be **difficult for the foreign company to claim credit of such taxes in either country**. Additionally, availability of favourable DTAA benefits, given the change in the residential status of the foreign company. However, this needs to be evaluated in further detail.

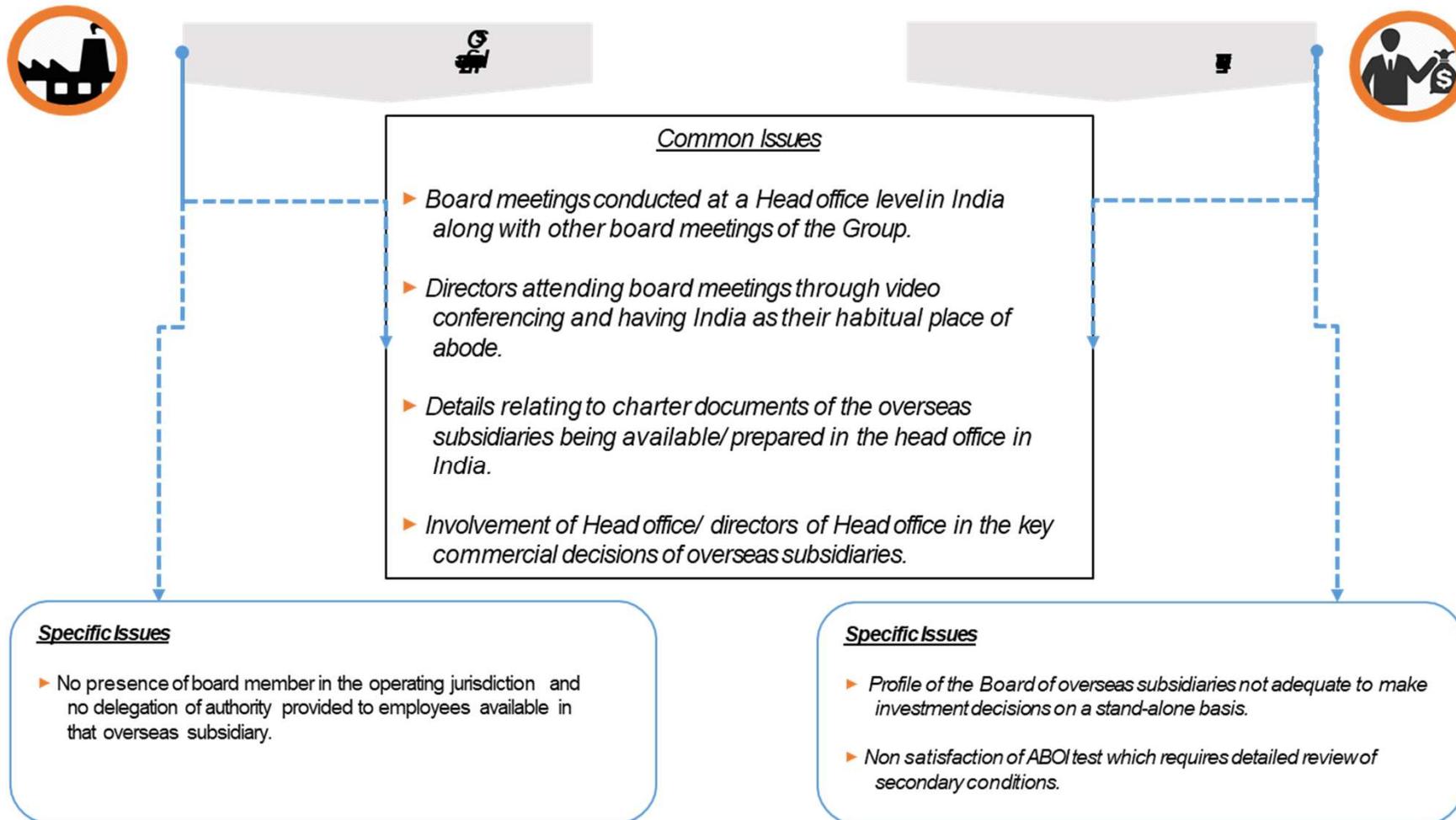
There are **certain tax exemptions/ incentives** which may apply only **to an Indian company** and may not extend to a foreign company though it turns tax resident. To list a few, exemptions on capital gains arising in transfer between a 100% subsidiary and its holding company .

## Place of Effective Management Consequence of PoEM being in India

If the transferee is an Indian Company (clauses iv, v of section 47 of the IT Act) and such similar clauses. The company may not be able to get benefit of carry forward or set off of past losses, since return of Income may not have been furnished in the past.

A Company if regarded as a resident of India as per the PoEM will be required to disclose all its foreign income as required under the ITR as per the provisions of BMIT Act. This refers to assets outside India (including financial interest in any entity), held by the Company (includes nominal and beneficial ownership). Failure to comply with the above could lead to penal consequences.

# Typical Industry Issues



Safe guard provided in procedure –  
applying PEOM on company incorporate  
outside India

AO – Initiating – after prior approval of Pr CIT/  
CIT

AO –proposed to hold- after prior approval of  
Collegium of three members consist of Pr CIT/  
CIT

Collegium before issue director – opportunity to  
company