

India further clarifies “POEM” rule for foreign corporation tax residence

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The Indian government on October 23 released more guidance on a foreign company's place of effective management ("POEM"), which is India's new test for corporate tax residence applicable to financial year 2016–17 and future years.

In its latest guidance, Circular No. 25 of 2017, the Central Board for Direct Taxes ("CBDT"), provides that general and non-specific functions carried out by an Indian regional headquarters would not lead to determination of POEM in India for its subsidiaries/ concerned group companies.

The CBDT has however added a caveat regarding the application of the General Anti-Avoidance Rules ("GAAR") where this new clarification to the POEM rules is used for tax abuse/aggressive tax planning.

India POEM rule – background

Previously, under India's domestic tax law (specifically Section 6(3) of the Income Tax Act, 1961), a foreign company was regarded as a tax resident of India only if it was 'wholly controlled and managed' in India.

This objective test of residence had been in place for around 100 years and hence was predictable for taxpayers. It also resulted in minimal tax litigation, a very positive situation given the adversarial positions often adopted by India's revenue authorities.

In 2015, the residence test was amended, providing that a foreign company was tax resident of India if its POEM was found to be situated in India.

The rationale was to bring Indian domestic law into conformity with India's double taxation avoidance agreements and with the OECD Model Tax Convention (refer Article 4(3)), which use the POEM test as a tie-breaker test.

The application of the POEM test was deferred to the financial year 2016-17. Final guidelines on the new rules were released January 24, through Circular No.06 of 2017, just two months before the end of the financial year 2016-17.

Subsequently, on February 23, the CBDT issued Circular No 8 of 2017 to clarify that the POEM provisions shall not apply to a company having turnover or gross receipts of INR 500 million or less (approx. USD 7.72 million) in a financial year.

Now, due to continued concerns expressed by various stakeholders, the CBDT has issued another clarification to provide additional guidance to the taxpayer.

POEM guidelines

The scheme of the POEM guidelines is to focus on substance over form and no single principle has been mentioned as being decisive.

The POEM of each company must be determined each year depending on the facts and circumstances of each case. A distinction is made between companies that carry on an "active business outside India" and companies that do not.

A company is considered to have an "active business outside India" if (i) its passive income is less than 50% of its total income, (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.

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. A foreign company not meeting these conditions is considered as a passive foreign company.

A very significant clarification has been made to the effect that foreign companies that carry on an "active business outside India" are presumed to have their POEM outside India if the majority of the board meetings of such companies taking place outside India.

This presumption is subject to the active exercise of the powers of managements by their respective boards. In other words, (as used in the POEM guidelines), the boards of the foreign companies should not be "standing aside" in favour of the exercise of control by their Indian holding company/shareholders, or any Indian resident persons.

To make this clearer, the PEOM guidelines explained that merely following general and objective principles of global policy of the group per se would not be considered to be evidence of the "standing aside of the board of directors of the concerned foreign company.

The new clarification

One concern expressed about the POEM guidelines is that while they address a situation where an Indian holding company had laid down general and objective directions for its offshore subsidiaries, they fail to capture the situation of a multinational company that has an India regional headquarters

with employees that have responsibilities or oversight over group companies situated in other jurisdictions.

Taxpayers have been concerned that, owing to the litigious and adversarial approach often adopted by India's tax authorities, the lack of express guidance could lead to litigation.

To assuage these concerns, the CBDT's new guidance expressly states that where an India-based regional headquarters acts for its subsidiaries/ group companies situated in its region of responsibility within the general and objective principles of global policy of the multinational group as laid down by the parent entity in areas such as the ones mentioned in the context of Indian holding companies (e.g., – payroll functions, accounting, human resource functions, etc.). However, these principles of global policy should not be specific to any entity or group of entities, the guidance states.

While this guidance a welcome move and reflects the intention of the Indian Government to take proactive steps in furtherance of its avowed objective of reducing tax litigation in the country, the clarification comes a rider.

The rider specifies that in cases where, in the opinion of the Indian tax authorities, the guidance is being used for abusive or "aggressive" tax planning, it would be open to tax authorities invoking the provisions of the GAAR which have recently come in force as per India's domestic tax laws.

The GAAR confers broad powers on the revenue authorities to deny tax benefits (including tax benefits applicable under a treaty), if the tax benefits arise from arrangements that are "impermissible avoidance arrangements."

POEM & GAAR

The entire theme of the POEM guidelines is "substance over form". This is evident from the fact that the POEM guidelines classify companies based on active and passive income, which is not usually associated with corporate residency but with measures related to anti-abuse.

The same rationale of codifying the doctrine of "substance over form" was expressed in the Memorandum of the Finance Bill, 2012 for the enacted of the GAAR provisions.

In view of the same, once a foreign company has met the conditions for being considered as nonresident in India as per the POEM guidelines, it can be harassment for the taxpayer to allow tax authorities to resort to the wide ambit of the GAAR provisions to question the POEM of a foreign company as being situated in India.

There can be no tax certainty in a jurisdiction unless there is an objective and unambiguous test for the determination of a taxpayer's tax residence.

In view of the same, while the Indian government has been proactive in issuing clarifications to the POEM guidelines to assuage taxpayer concerns, this may not be sufficient.

The previous test for residency was in place for a very long time and there exists sufficient binding judicial decisions regarding the interpretation of the same. This is in stark contrast to the ambiguity and lack of judicial guidance for the interpretation of the POEM guidelines and the GAAR provisions.

As such, it may be advisable for the Indian government to re-think whether this change in the test for corporate residence to the POEM test was indeed a good move. Although these clarifications by the CBDT are helpful, the POEM test continues to be subjective and not be water tight-

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