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Govt may abolish ‘place of effective mgmt’ tax

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Mumbai: The forthcoming budget is likely to introduce the concept of 'Controlled Foreign Corporation' (CFC) as an anti-avoidance measure. At the same time, the more subjective concept of taxing a foreign company if its 'place of effective management' (POEM) is in India may be done away with. This move is expected to help Indian companies with overseas subsidiaries as also MNCs with operations in India.

POEM was first introduced in Budget 2015 with effect from April 1 of the same year. However, as only draft guidelines were in place, Budget 2016 deferred its application to the fiscal year 2016-17.

Currently, the provisions relating to POEM are in force, even as final guidelines are still awaited. Earlier a foreign company (be it a subsidiary of an Indian company or parent of an Indian company) was not subject to income tax (I-T) in India unless its affairs were 'wholly controlled and managed' in India. In general terms, this meant that a tax incidence would not arise in India, unless the entire decision-making team was in India.

Now, since April 1, 2016, a foreign company has the risk of a tax exposure in India if its POEM is considered to be in India — the determination of which is subjective according to tax experts. Government officials admit that the framework of CFC as also the challenges faced by companies under POEM have been discussed in the run-up to the budget.

"A CFC regime with adequate checks and balances can protect the revenue's interest without jeopardising business houses whose global income can be caught within the Indian I-T net on account of ill-conceived POEM regulations. POEM could be used as a harassment tool and create huge uncertainty in India, especially as there is no jurisprudence on the subject," says Nishith Desai, founder of the law firm Nishith Desai Associates.

Mukesh Butani, managing partner at BMR Legal, explains, "If at all anti-avoidance provisions are required — in addition to general anti-avoidance rules (GAAR), which will be introduced from April next — a CFC route is a better alternative. CFC regulations cover unlisted foreign companies, set up in low-tax countries that are owned and controlled by Indian resident holders, where the passive income (such as interest, dividend, capital gains, transactions with related parties) is accumulated overseas instead of being repatriated back to India. A CFC does not result in the foreign company being treated as an Indian taxpayer. Rather, it isolates the passive income of the foreign company and subjects only such income to tax in the hands of the Indian shareholders."

On the other hand, the process of determination of POEM is primarily based on whether or not the foreign company is engaged in 'active business' outside India. To meet the 'active business' test, its passive (non-business) income should not be more than 50% and it should meet certain parameters in terms of employees, assets and payroll expenditure.

"However, subjectivity creeps in even if the foreign company has an active business outside India. Practical aspects such as common directors on the board of the Indian parent company and its foreign subsidiary could trigger a POEM exposure for the foreign subsidiary and a tax incidence in India. Location of professional leadership teams in both India and the foreign country could also result in a POEM exposure. Under POEM, we are discouraging MNCs from locating their regional headquarters in India or holding board meetings in India," says Butani.

Properly drafted CFC norms would provide more clarity and mitigate litigation as compared to POEM, sum up tax experts.