Tax Hotline

July 12, 2018

POEM IN INDIA? CBDT ISSUES FINAL NOTIFICATION ON TAX CONSEQUENCES!

- Foreign companies having POEM in India placed at a disadvantage as compared to domestic Indian companies.
- A foreign company shall continue to be treated as a foreign company even if it is said to be resident in India as per the POEM test.
- Tax rate for a foreign company to remain the same, i.e. 40% (exclusive of surcharge and cess) even where it is deemed to be an Indian resident company.
- Transactions of foreign companies to remain unaltered on the basis of such companies becoming India resident on account of the POEM test.

Recently, the Central Board of Direct Taxes ("**CBDT**") issued final Notification under Section 115JH of the Income-tax Act, 1961 ("**ITA**") which provide tax consequences on a foreign company said to be resident in India due to its place of effective management ("**POEM**") being in India ("**Notification**").[1] This Notification is applicable from the financial year 2016-17.

BACKGROUND

Previously, under Section 6(3) of the ITA, a foreign company was regarded as a tax resident of India only if it was 'wholly controlled and managed' in India. This test of residence was predictable for taxpayers and had been in place for around 100 years. Being a very objective test, it also resulted in minimal tax litigation on the issue of residence of a taxpayer. In 2015, the residence test was amended, and it was prescribed that a foreign company will be considered as an Indian tax resident if its POEM was found to be situated in India. The POEM test has come into force from the financial year 2016-17. Please click here to read our hotline on the guidelines issued by the CBDT regarding the determination of a POEM.

Special provisions in relation to foreign companies considered to be resident in India by virtue of the new POEM test were introduced in the ITA by way of the Finance Act, 2016 through insertion of a new Chapter XII-BC comprising Section 115JH in the ITA with effect from April 1, 2017.

On 15 June, 2017, the CBDT had issued a draft notification under section 115JH of the ITA to invite comments from stakeholders and public ("**Draft Notification**"). Now, the CBDT has issued the final Notification which expands on the Draft Notification.

THE NOTIFICATION

Determination of Written Down Value and Brought Forward Loss:

The Notification lays down the manner in which the written down value ("WDV") of a depreciable asset as well as the brought forward loss and unabsorbed depreciation for the purposes of carrying forward and setting-off are to be calculated in case of an India resident foreign company:

- Situation 1: Where the foreign company is assessed to tax in the foreign jurisdiction

  Where depreciation is taken into account while computing taxable income, the WDV of a depreciable asset shall be determined as per the company's foreign tax records. Where depreciation is not taken into account, the WDV is to be calculated as per the provisions of the laws of that foreign jurisdiction. The brought forward loss and unabsorbed depreciation shall be determined year wise on the basis of the foreign tax records of the company.

- Situation 2: Where the foreign company is not assessed to tax in the foreign jurisdiction

  The WDV and the brought forward loss and unabsorbed depreciation (year wise) is to be determined on the basis of the books of account, maintained in accordance with the laws of the jurisdiction in which company is incorporated.[2]

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Preparation of Balance Sheets for period before a company becomes India resident

In cases where the accounting year of the foreign company does not end on 31st March, it shall be required to prepare profit and loss account ("**P&L account**") and balance sheet for the extended period starting from the date on which its accounting year begins, up to 31st March of the year immediately preceding the financial year during which the foreign company has become resident ("**Extended Period**"). However, where this Extended Period is:

a. less than six months, it shall be included in that accounting year;
b. equal to or more than six months, that period shall be treated as a separate accounting year.

The foreign company shall also be required to prepare profit and loss account and balance sheet for succeeding periods of twelve months till the year the foreign company remains resident in India on account of the POEM test.

Example: In case a foreign company follows the calendar year as its accounting year, and becomes resident in India in the financial year 2018-19, its shall prepare balance sheets and P&L accounts for January 1, 2018 to March 31, 2019 as one year. However, if the accounting year followed by the foreign company is from July 1 to June 30, it shall prepare separate balance sheets and P&L accounts for the period of July 1, 2017 to March 31, 2018.

In a situation where the foreign company's accounting year does not end on March 31, its unabsorbed depreciation shall be allocated on a proportionate basis.

Foreign Tax Credits

The Notification expressly states that a foreign company shall be entitled to relief or deduction of taxes paid in accordance with the provisions of Section 90 or 91 of the ITA. Therefore, a foreign company shall be eligible to avail benefits of India's tax treaties after it becomes resident in India.

In a case where income on which foreign tax has been paid or deducted is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India in respect of the income to which it relates in accordance with applicable rules.

Conflict between provisions:

The Notification clarifies that a foreign company shall continue to be treated as a foreign company even if it is said to be resident in India on account of the POEM test and all the provisions of the ITA shall apply accordingly. As a result, provisions of the ITA which are specifically applicable to either a foreign company or a resident taxpayer shall be applicable to such companies. On the other hand, provisions relating to non-residents shall not be inapplicable in such cases. It has been further clarified that in case of any conflict between provisions of the ITA applicable to a taxpayer as a foreign company and the provisions of the ITA applicable to it in its capacity as a resident, the former shall prevail over the latter.

Also, specifically in the case of the provisions of the ITA dealing with tax deductions at source ("**TDS**") (as enshrined in Chapter XVII-B of the ITA), the Notification expressly states that where more than one provision applies to an India resident foreign company, the provision applicable to the foreign company alone shall apply. Compliance with the provisions which are applicable to the foreign company prior to its becoming Indian resident shall be considered sufficient compliance with the TDS related provisions of the ITA. This may lead to an illogical result where a resident may be required to withhold taxes on payments to a foreign company even after such foreign company becomes an Indian resident.

Transfer Pricing:

It has been expressly provided that all transactions of the foreign company with any other person or entity under the ITA shall not be altered only on the ground that such foreign company is treated as a resident on account of its POEM being in India. This should lead to a result that transfer pricing provisions continue to apply even if a foreign associated enterprise is considered resident in India as per the POEM test.

Rate of Tax

In case of conflict between the provision applicable to the foreign company as resident and the provision applicable to it as foreign company, the later shall generally prevail. Therefore, the rate of tax in case of foreign company shall remain the same, i.e., rate of income-tax applicable to the foreign company even though residency status of the foreign company changes from non-resident to resident on the basis of POEM.

Limitation on setting off against India sourced income

The Notification clarifies that the losses and unabsorbed depreciation of the foreign company shall be allowed to be set off only against such income of the foreign company which have become chargeable to tax in India on account of it becoming an Indian resident. Further, it has been clarified that the Notification does not apply to such income of any foreign company which was taxable in India irrespective of the residence status of such foreign company (e.g.- India sourced income of a foreign

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company). This provision did not feature in the Draft Notification and is an unwelcome surprise for taxpayers.

Treatment in Subsequent Assessment Years

Where a foreign company continues to be resident in India the exceptions, modifications and adaptations referred to in the Notification shall also apply to subsequent assessment year, provided that the WDV, the brought forward loss and the unabsorbed depreciation to be adopted on the 1st day of the previous year shall be those which have been arrived at on the last day of the preceding previous year in accordance with the provisions of the Notification.

ANALYSIS

Since the POEM test has come into force, it was expected that the CBDT should come out with the final notification under Section 115JH to provide certainty to taxpayers. Certain aspects such as the treatment of an India resident foreign company in subsequent assessment years which were not covered in the Draft Notification have been expressly included in the Notification after receiving comments from various stakeholders.

However, the Notification may still leave a bad taste in the mouth of taxpayers. For instance, the insistence of the CBDT to tax a foreign company at a higher rate of 40% (exclusive of surcharge and cess) even though it has become a tax resident of India by virtue of POEM is bound to cause heartburn among foreign taxpayers. This is because where on one hand the entire global income of an India resident foreign company is being sought to be brought to tax in India, this is being done at a higher rate as compared to domestic companies (for whom the rates have recently been brought down). Also, when a foreign company is being treated as an Indian resident, it may still have to comply with the transfer pricing related provisions of the ITA while transacting with Indian associated enterprises. This may seem illogical given that the objective of transfer pricing is to prevent profit shifting between different tax jurisdictions. Similarly, for withholding taxes, the Notification provides that provisions which are applicable to the foreign company prior to its becoming Indian resident shall be considered sufficient compliance with the TDS related provisions of the ITA.

Further, as per the Notification it appears that an India resident foreign company is only allowed to set-off its carried forward loss against that portion of its income which was not already taxable in India. This means that while a domestic company is allowed to set-off and carry forward loss relating to its India sourced income, an India resident foreign company is restricted from doing so as this income was already taxable in India even where such company was a non-resident. This puts foreign companies at a disadvantage and this move is certain to be looked at unfavourably.

To summarize, it seems that the intention of the CBDT here is to maximize revenue collection by differentiating between entities which are residents of India by virtue of their being incorporated in India and those entities which are India resident by virtue of the POEM test and taxing the latter class at a higher rate. Since India taxes companies based on their residence status it is relevant to question the constitutional validity of such a discrimination between two classes of resident companies by the CBDT as, prima facie, there does any ground which allows for such a discrimination. It will be interesting how the rules play out and what the exact impact of such rules will be.

– Shashwat Sharma & Ashish Sodhani
You can direct your queries or comments to the authors

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[1] CBDT Notification No. 29/2018 dated June 22, 2018.

[2] In case there is any revision or modification in the foreign jurisdiction with respect to the brought forward loss and unabsorbed depreciation originally adopted in India due to any action of the tax or legal authority in the foreign jurisdiction, the amount of the loss and unabsorbed depreciation shall be revised or modified for the purposes of set off and carry forward. This clarification had not featured in the Draft

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