Tax Hotline

August 14, 2018

NETHERLANDS ENTITY HELD TO BE RESIDENT OF CANADA: CANADIAN TAX COURT RULES ON POEM!

- Netherlands incorporated company held to be resident of Canada pursuant to its place of effective management in Canada.
- Court holds place of effective management to be where the shareholders who have effective control over the company are located.
- Mere performance of administrative and clerical tasks by director cannot tantamount to being considered effective management.

The Tax Court of Canada (the "**Court**") recently, in the case of *Landbouwbedrijf Backx B.V. v. The Queen*[1], ruled that the place of effective management of an entity was the jurisdiction where its shareholders were located as they were taking decisions about the running of the company and the director of the company was only performing administrative and clerical tasks and hence was not effectively managing the company.

FACTS

Landbouwbedrijf Backx B.V. ("**Taxpayer**") (a limited liability company was incorporated in Netherlands with two individuals who were residents of the Netherlands. The shareholders were also directors of the company. The shareholders owned and operated a dairy farm in the Netherlands, which was transferred to the Taxpayer shortly after the date of incorporation. As part of the consideration for the transfer, a life annuity having a term of 46 years was created in favour of the shareholders.

The shareholders then immigrated to Canada and, prior to doing so, the Taxpayer sold the bulk of the Netherlands Farm to a third party. The shareholders resigned as directors and a resident of the Netherlands was appointed as the director. The Taxpayer then went onto purchase a dairy-farm operation in Canada in partnership with a company incorporated by the two shareholders in Canada. The Canadian company held 51% interest in the farm while the Taxpayer held 49% interest in the farm. The Taxpayer, subsequently, disposed of its 49% partnership interest to the Canadian company for consideration which resulted into a capital gain for the Taxpayer. However, the Taxpayer contended that since the property was a "treaty-protected property" as per the Canada – Netherlands Tax Treaty (the "**Treaty**") no withholding tax on payment to the Taxpayer should be a applicable. This position was accepted by the Minister of National Revenue ("**Minister**"). However, while passing the assessment, the Minister held that the partnership interest was not a "treaty-protected property", since the Taxpayer was not a resident of the Netherlands but of Canada.

The Appellant filed an appeal against such assessment order of the Minister.

APPELLANT ARGUMENTS

To establish its stand of being a resident of the Netherlands, the Appellant, *inter alia*, argued that it was incorporated in the Netherlands, had been filing its tax returns there and all the transactional documents with respect to the sale of the farm to the Canadian company was signed by the Director who was a resident of the Netherlands. The Appellant further contended that for eleven financial years prior to 2009, it had filed as a non-resident for Canadian tax purposes and was being assessed as the same. On the basis of the above, the Appellant stated argued that any capital gain should only be taxable in the Netherlands pursuant to the Treaty.

RESPONDENT ARGUMENTS

The Respondent, on the other hand, contended that notwithstanding the fact that the Appellant was incorporated in Netherlands, it was managed and controlled by its shareholders and the director was responsible for only administrative tasks in the Netherlands.

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RULING

The Court observed that Canada follows source-based taxation for non-residents and the capital gains realized out of disposition of any "taxable Canadian property" should be taxable under the income tax laws of Canada, unless such property falls under the meaning of "treaty-protected property" and thus is exempt as per the relevant tax treaty.

The Court stated that the common law test for determination of residency status is the central management and control test[2]. The Court further observed that "central management and control" of a corporation should generally be the place where the board of directors of such corporation resides notwithstanding that the directors may be under significant influence of the shareholders.[3] However, in case significant management decisions of such corporation are taken by a person other than a director, then the place where such person resides may be considered as the place of residence of such corporation[4].

The Court analyzed various judicial precedents and observed that an outsider who dictates the decisions of a company may be considered as a *de jure* director as opposed to an outsider who merely proposes, advises and influences decisions of a company and there should be cogent evidence(s) to establish such authority.

The Court observed that the director had admitted that she had no farming or prior business experience. The Director only assisted the shareholders, paid bills on behalf of the Taxpayer based on the instructions provided by the shareholders and delivered financial documents to accountants pursuant to request of the shareholders. The Court further observed that the director did not participate in the decision to dispose of the partnership interest but merely executed the requisite documents to implement a decision made by the shareholders.

Hence, in view of the above observations, the court concluded that since the shareholders assumed effective and independent control over the Appellant and the director merely performed clerical and administrative functions on behalf of the shareholders, the Taxpayer was a resident of Canada and thus, as per the Treaty, Canada was authorized to tax Appellant's capital gains. The Court further ruled that in the event the Appellant is a resident of both the states (in the Netherlands on account of its domicile and in Canada on account of its place of effective management), then such issue should be resolved by the competent authorities of both the countries as per Article 4(3) of the Treaty.

ANALYSIS

The concept of place of effective management ("**POEM**") has gained significant importance in the recent times especially in the Indian context. India earlier had the "wholly controlled and managed" test wherein companies were considered to be Indian residents if they were wholly controlled and managed from India. The test was objective in nature and was considered much more advanced than what other nations had – the Place of Effective Management ("**POEM**") test. While India introduced the POEM test to replace its age old control and management test in the year 2016, world over, this test is the norm.

To give a little history about the POEM test, it is interesting to note that in the League of Nations Mexico Model of 1943, the residence (called fiscal domicile) of companies was defined to be the place where they were constituted.[5] This was changed in the London Model of 1946 to "the State in which its [the company's] real centre of management is situated".[6] The Commentary to both the Mexico and London Models provided that the latter formula was used in most tax treaties concluded between European countries.[7] The next proposal for the tie-breaker, that a company was resident at the place where the company was managed and controlled,[8] was put forward by Working Party 2 (on fiscal domicile) of the OEEC Fiscal Committee, whose members were from Denmark and Luxembourg. The change from "management and control" to the currently used "place of effective management" came about in the year 1958.

As India has just introduced this concept in its domestic law and there is no precedent that exists, understanding the contours of what all can result in a company having its POEM in India becomes significant and hence foreign court rulings such as these also gain importance. These rulings may prove worthwhile in comprehending the concept of POEM since the test of POEM in India has been borrowed from international jurisprudence and therefore its interpretation by courts / tribunals of different countries may provide much needed guidance to Indian tribunals / courts. In fact, a similar ruling was given by United Kingdom's First Tier Tribunal ("**Tribunal**") last year in the case of R*ichard Lee & Nigel Bunter v. The Commissioner for Her Majesty's Revenue and Customs, [2017] UKFTT 279 (TC) ("Richard Lee"),* wherein the Tribunal had held that place of effective management ("**POEM**") of trusts set up in Guernsey was in United Kingdom ("**U.K.**") *(Read our hotline on this case here).* In *Richard Lee*, two Guernsey based trusts had U.K. settlors and a Mauritius based trustee at the time of transaction of transfer of shares. The Tribunal had ruled, similar to the present case, that irrespective of the execution of the transaction taking place in Mauritius (by virtue of the trustees situated in Mauritius), the POEM of the trusts was in U.K., since the trustees were acting under the instructions of the settlors situated in U.K. The Tribunal took more of a fact-based approach wherein it analyzed the correspondence between the settlors and lawyers with the Mauritius administrators. The Tribunal observed that the Mauritius director lacked business acumen or basic understanding of the concerned

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transaction and hence was incompetent to exercise independent decision making.

To provide guidance on the determination of POEM in India, the Central Board of Direct Taxes ("**CBDT**") had issued a Circular, dated January 24, 2017, comprising of guiding principles ("**POEM Guidelines**") to be followed for determination of POEM of a foreign company. Various similarities may be drawn between the above-mentioned rulings and the Guidelines. The courts in the above rulings scrutinized as to who was responsible for making the final decisions in relation to the transactions and determined the control and management on such basis. The POEM Guidelines also state that the substance shall take over form and the POEM determination should be done on a case-to-case basis. These guidelines further state that the activities performed by a foreign company over a long period of time will be considered and there will be no strait-jacket formula for determination of POEM. Furthermore, the POEM Guidelines provide that having Indian directors, local management in India or Indian support function would not be conclusive of POEM in India. This is akin to the above judgments wherein it was observed that engagement of legal / professional advisors was irrelevant for the determination of the POEM.

In light of the above two rulings, it is unlikely that a company would pass the test of POEM in India on the basis of administrators carrying out the day-to-day administrative and clerical activities of the entity, key decisions being executed outside India but authorized in India.

Typically, from an Indian perspective foreign entities are advised that board meetings should be conducted outside India where the decision making is carried out, and documentation concerning such board meetings should also be properly maintained. However, the POEM Guidelines specifically state that the mere recording of board minutes will not be reflective of necessary control or management. Therefore, to minimize the risk of POEM, it would be advisable for Indian global entrepreneurs who carry out operations outside India but spend considerable time within India to undertake their key decision making activities outside India.

Additionally, the CBDT recently issued final Notification, dated June 22, 2018 (the "**Notification**") and applicable from the financial year 2016-17 (in furtherance of the draft notification issued on June 15, 2017) in relation to tax consequences on a foreign company said to be resident in India on account of its POEM in India. The Notification provides clarifications and guidelines related to, *inter alia*, availing of foreign tax credits, applicability of the provisions of the Tax Act, rate of tax and transfer pricing.

In light of the present ruling as well as other judicial precedents cited and relied upon by the Court in this case, it becomes relevant for the companies having foreign shareholders to determine the extent of participation such shareholders should have in its decision making process. This gains more important in present times considering many of a company's transactions may require its shareholders' prior approval. Therefore, the companies should be mindful of whether its transactional and management decisions are to be made "in consultation with the shareholders" or "with the consent of the shareholders".

– Prakhar Dua & Ashish Sodhani
You can direct your queries or comments to the authors

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[1] 2018 TCC 142.

[2] *Garron Family Trust (Trustee of) v. R.,* (2012) SCC 14

[3] *St. Michael Trust Corp. v. Canada, 2010 FCA 309 ("St. Michael Trust")* (paras. 54-55), *Birmount Holdings Ltd. v. R.* (1978), 78 DTC 6254, at para. 33 ("*Birmount*") and *Bedford Overseas Freighters Ltd. v. Minister of National Revenue*, [1970] CTC 69, 53 ("*Bedford")*

[4] *St. Michael Trust; Bedford.*

[5] Art. II (4) of the protocol to the Mexico Model.

[6] Art. II (4) of the protocol to the London Model.

[7] Commentary to the London and Mexico Model Tax Conventions, League of Nations, Geneva (1946), Commentary ad Art. 1, Legislative History of US Tax Conventions, Vol. 4 ("Legislative History"), at 4331, available on the University of Sydney web site:
http://setis.library.usyd.edu.au/oztexts/parsons.html

[8] The treaties France-Switzerland (1937) and Hungary-Romania (1932).
