

## Tax Hotline

December 28, 2015

### POEM: NEW CRITERIA FOR CORPORATE TAX RESIDENCE IN INDIA

On December 23, 2015, the Indian tax authorities released draft guidance for determining the 'place of effective management' ("POEM") of a company. The public has been offered a limited window till January 2, 2016 to provide comments. To be reasonable, more time (at least 45 days) should be provided for a more thorough review, especially considering the importance of the issue and serious ramifications for funds, Indian MNCs and start-ups.

Released around 9 months after the effective date (i.e. April 1, 2015) of India's new test of corporate residence, the draft guidance only increases uncertainty for taxpayers. Close to the end of the year, several Indian MNCs are put in a quandary on an issue as fundamental as corporate tax residence. Even foreign companies doing business in India and overseas funds are impacted. Further, it also poses enforcement challenges and costs on the tax department in terms of data collection and review.

The shift to POEM signifies a shift from an objective criterion for tax residence to subjective criteria and is a very serious matter for taxpayers. The earlier criterion was based on place of incorporation or the place where the company was 'wholly' controlled and managed. It was introduced in the Income Tax Act of 1922, which was an improvement over the antiquated and vague concept of place of effective management (in Europe) and central control and management (in the UK). For almost 100 years, there was hardly any litigation on the subject in India. Countries such as the US do not use POEM for determining corporate residence which provides certainty for MNCs. In fact, India adopted a similar standard way back in 1922 which was comprehensively reviewed by the Law Commission in 1958 and retained in the Income Tax Act of 1961. India should eschew new subjective tax provisions till the tax environment comes under reasonable control and investors and companies are more confident.

### THE POEM TEST AND RECENT DRAFT GUIDANCE

Till 2015, a foreign company would have been considered resident in India (and taxed on worldwide income) only if it was 'wholly' controlled and managed in India. From April 1, 2015 a foreign company may be treated as an Indian resident if its place of effective management (POEM) is in India. POEM refers to the place where key management and commercial decisions necessary for the business as a whole, are in substance made.

The draft guidance emphasizes that the test of POEM is one of substance over form and will depend on facts and circumstances of each case. While a company may have more than one place of management, it can only have one place of effective management at any point in time.

The guidance contemplates different tests for companies with active and passive businesses outside India. An active business is one where less than 50% of the income is passive and less than 50% of its employees are situated in India, with payroll expenses on such employees being less than 50% of total payroll expenses. Passive income covers dividends, interest, royalties, capital gains, rent and income from related party transactions.

The POEM for an active company is presumed to be outside India if the majority of its Board meetings are held outside India. This presumption would not apply if management authority is exercised by a person other than the Board, who is resident in India. This determination will be made based on data over the past 3 years, or lesser if the company has been in existence for lesser than 3 years.

To determine the POEM of passive companies, the persons who actually make key management and commercial decisions for the business as a whole will be identified, followed by identifying the place where decisions are actually taken.

The following guiding principles would be considered while determining POEM of a company:

- Location where the Board regularly meets, provided it retains and exercises governing authority over the company and in substance takes key management and commercial decisions.
- The place where key decisions are in fact taken would have more relevance than where formal Board meetings are held.
- If the Board routinely ratifies decisions made by senior management, executive committee or any other person, the place where such person takes decisions will be considered as POEM.
- The location of a company's head office is an important factor and the following facts have to be considered in this regard: (i) Location where the company's senior management and support staff are based and which is held out to the public as its headquarters. (ii) In a more decentralised company, the head office would be the place where the senior management is predominantly based, normally return to after travel, or meet when formulating key strategies or policies for the company as a whole. (iii) If senior management permanently operate from different locations, and participate in meetings via telephone or video conferencing, the location of the highest level of management such

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- as the managing or financial director will be considered as the head office. (iv) The head office would not be of much relevance in a highly decentralised company where it is not possible to determine its location with reasonable certainty.
- Day to day routine operational activities of junior or middle management are not relevant for determining POEM.
  - With the use of modern technology, physical location of meetings may not be where the key decisions are in substance made. In such situations, place of residence of majority of directors or decision making persons may also be a relevant factor.
  - As secondary factors, place of main and substantial activity of the company and place where accounting records are kept may be considered if the primary factors are inconclusive.
  - Ownership of a foreign company by an Indian company, residence of some of the directors of the foreign company in India, location of local management of a foreign company in India and existence of support functions of preparatory or auxiliary character in India will not be conclusive of POEM in India.
  - The above principles are only for guidance and no single principle will be conclusive. Activities performed over a period of time during a financial year should be considered rather than a 'snap shot' approach. If POEM is found to be in India as well as outside, it will be presumed to be in India if it has been predominantly in India.
  - The tax officer will require prior approval from the Principal Commissioner or the Commissioner while treating a foreign company as a resident based on POEM, after providing an opportunity of being heard.

## SPECIFIC IMPLICATIONS, COMMENTS AND SUGGESTIONS

**Re-think POEM:** The mere fact that POEM is prevalent in other countries is not a justification for introducing it in India. In most of these countries the tax system is not adversarial to the tax payer and the risk of litigation is lower than in India. Companies do not generally consider POEM as a risk factor while managing their global operations as for a long period jurisprudence there is well settled. Countries such as the US focus on the place of incorporation and do not bother about whether a non-US company is effectively controlled in the US.

**Risk of Double Taxation:** Unilateral approaches often result in double taxation since there is no guarantee that the other country will accept India's determination of a company's POEM. This risk is more significant for US companies founded or held by India based entrepreneurs since the US tax treaty does not recognize the concept of POEM. The US is likely to remain a major partner for investment and transfer of technology and the risk of double taxation could have serious consequences. It would be in-appropriate for India to unilaterally disregard a tax residency certificate provided by a foreign country based on its determination of a company's POEM. It seems that the only way to guarantee that there will be no double taxation is for the Indian Government to enter into specific agreements (either as a treaty protocol or through mutual agreement procedure) with each country to clarify the scope of POEM.

**Risks for fund managers:** Overseas funds, including those based in Mauritius and Singapore, usually have investment committees based in their relevant jurisdiction that makes decisions regarding investments and exits. However, there is risk that they may be taxed as Indian residents if they are seen to routinely approve recommendations by fund managers based in India. The relief provided in the Finance Act 2015 for broad based funds outside India does not provide sufficient protection against this risk of global taxation posed by POEM.

**Making India Inc. non-competitive:** Indian MNCs and start-ups now have to carefully factor the risk of global taxation of their overseas subsidiaries (and double taxation) to the extent there is management and oversight from India. This can complicate globalization efforts, increase costs of managing overseas subsidiaries or holding companies and reduce global competitiveness.

**Brain drain:** With the implementation of POEM, there is further incentive for Indian companies to relocate founders and senior management overseas to minimize the additional tax exposure and risk of double taxation. In recent times, there has been a noticeable exodus of top fund managers from India. This can thwart the Government's active efforts to promote the much celebrated 'Make in India' initiative, since subjective rules like POEM makes it more difficult to do business in India and with India.

**Subjectivity and litigation risks:** Litigation risks in India have been a sore point for investors and the Government has in the recent past made some positive attempts to reign in high pitched and frivolous tax assessments. The root cause for uncertainty and litigation is subjective and ambiguous tax rules. With provisions such as the general anti-avoidance rules ("GAAR") dealing with cases of taxpayer abuse, it may be difficult to be too objective. But, something as fundamental as a company's residence should not be a matter of subjectivity. There is no sense in replacing the earlier 100 year old rule for corporate residence that ensured maximum certainty without creating double taxation outcomes for companies. The draft guidance provides in-sufficient clarity for companies to plan their affairs. The distinction between active and passive companies has limited rational nexus with corporate residence. The location (or existence) of a head office, residence of directors and other factors are irrelevant in a technology enabled world that makes decisions on the cloud.

**Burden of proof:** When the POEM of a foreign company is alleged to be in India, it is important that the burden of proof is primarily on tax department. This may require analysis and review of stacks of documentation and emails in relation to decision making which will be impossible to obtain in most cases. Further, much of this information may be subject to client-attorney privileged communication and hence not subject to disclosure.

**Separate tools to counter abuse:** A number of tools may be deployed by tax authorities to counter abusive cross-border structures, which include transfer pricing, GAAR, treaty based anti-conduit or limitation of benefits criteria and others. POEM is not such a tool. For taxing overseas subsidiaries located in tax havens, India may in the future introduce controlled foreign corporation ("CFC") rules after ensuring full credit for foreign taxes.

**Cost of enforcement and difficulties for tax authorities:** The cost of objectively determining POEM of a foreign company including securing and analysing relevant information itself can be quite prohibitive. It is also important to consider other costs which may not be very apparent. For example, overseas funds and financial institutions treated as Indian residents based on POEM may be subject to reporting obligations under the US-India FATCA treaty and the Government would have to put in place a mechanism to collect and transmit such information. Subjective rules

also makes life difficult for tax officers since it may result in varying interpretations and there is always a risk of inquiries from central vigilance if decisions are taken in favour of taxpayers. Costs associated with litigation will impact the Government as much as the taxpayer.

**Timing is key:** Today, when the Government's focus is to provide a boost to India Inc. and incentivize globalization efforts, this is not the time to implement POEM or introduce a CFC rule. There is also a need for more thorough review of these rules in line with policy objectives. A limited 2 week window is inadequate to assess such rules, especially considering the serious and widespread ramifications among stakeholders.

## CONCLUSION

There is still much thinking to be done in India regarding whether introduction of POEM is a step in the right direction. The POEM standard should not be enforced in a hurry especially considering that the draft guidance has been released almost after 3 quarters of the financial year have passed. It will place an unreasonable burden on taxpayers and tax officials, both in terms of maintaining data relating to corporate decision making and reviewing enormous volumes of data at the time of tax assessments.

There is clearly a strong basis for India to avoid introducing subjective standards like POEM which can have a serious impact on the business environment. Till there is a more comprehensive review of the POEM standard, it has to be deferred.

– International Tax Team

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