

POEM – a new test of residency

Bhaumik Goda

19 May 2018

BGSS & Associates

Chartered Accountants

Where Passion Delivers Value

Paradigm shift

Prior to amendment

A company is said to be resident in India if:

- It is an Indian company
- During that year, the control and management of its affairs is situated wholly in India

Post amendment

A company is said to be resident in India if:

- It is an Indian company
- Its place of effective management in that year is in India

Place of effective management means a place where key management and commercial decisions that are necessary for conduct of the business of an entity as a whole are in substance made

Rationale for change

Circular No 19/2015 explaining provisions of Finance Act 2015

“Due to the requirement that whole of control and management should be situated in India and that too for whole of the year, the condition had been rendered practically inapplicable.

A company could easily avoid becoming a resident by simply holding a board meeting outside India. This could facilitate creation of shell companies which are incorporated outside but controlled from India

'Place of effective management' (POEM) is an internationally recognized concept for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognise the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. Many countries prefer the POEM test to be appropriate test for determination of residence of a company

Rationale for change

Circular No 19/2015 explaining provisions of Finance Act 2015

The modification in the condition of residence in respect of company by including the concept of effective management would align the provisions of the Act with the Double Taxation Avoidance Agreements (DTAAs) entered into by India with other countries and would also be in line with international standards. **It would also be a measure to deal with cases of creation of shell companies outside India but being controlled and managed from India.**

- Explanatory circular indicates that provision are intended to treat shell companies managed from India as resident company
- POEM is internationally recognised concept in determining residency
- Will aforesaid have any bearing on interpretation ? Can POEM be used to treat genuine companies as resident by applying clumsily worded guidelines ? Is POEM an anti-abuse provision or a potential abusive test of residency

Consequences of POEM

- Worldwide Income taxable in India at 40% (plus surcharge/cess)
- Applicability of TP provision including reporting of international transaction and maintenance of TP documentation
- Denial of treaty benefit in India-US treaty on account of dual residency
- Applicability of withholding provisions – unless payment falls within source rule exclusions under domestic law
- Compliance in form of filing of ROI, TDS return, equalisation levy etc
- Interest and penalty in cases where POEM is determined in India during tax scrutiny
- Payer can also be treated AID in case where relief is considered under treaty and subsequently POEM of payee turns out in India

Understanding POEM

Place of effective management means a place where key management and commercial decisions that are necessary for conduct of the business of an entity as a whole are in substance made

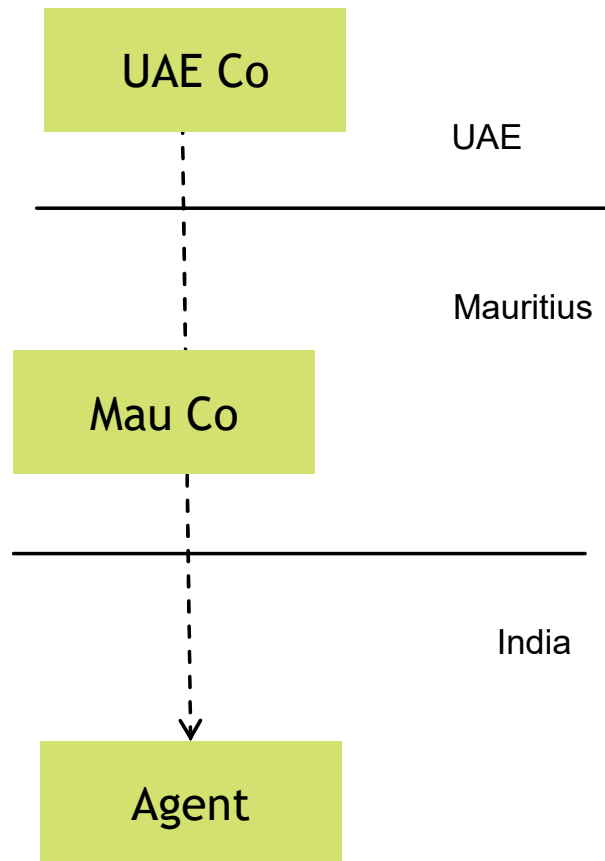
Term	Meaning
Key	Central importance, vital element
Management	Government, control, superintendence, the act of managing by director or regulation or administration
Commercial	Relating to commerce, dealing with commerce from point of view of profit
In substance	In essence, reality, distinguished from form
Made	Cause to exists or happen, put into existence

POEM and tax treaty

POEM and tax treaty

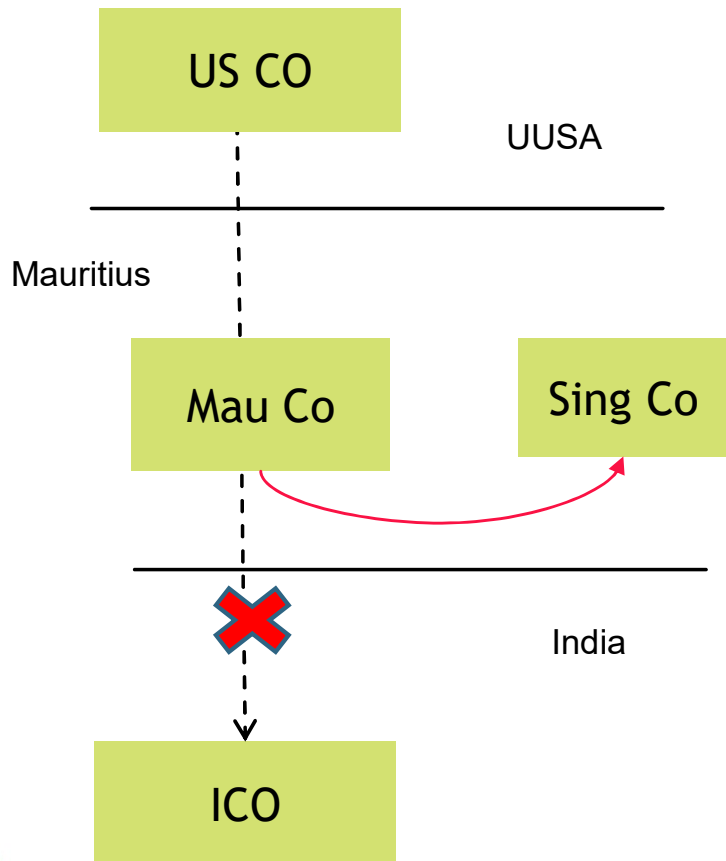
- Accepted test for treaty tie breaker rule in case of dual resident company
- OECD Commentary provides for consideration of following factors to determine POEM
 - Where meetings of the persons board of directors or equivalent body are usually held
 - Where chief executive office and other senior executives usually carry on their activities
 - Where the senior day to day management of the person is carried on
 - Where the persons headquarters are located
 - Which country laws govern the legal status of the person
 - Where its accounting records are kept

Bay Lines (Mauritius)



- Taxpayer is shipping company incorporated in Mauritius. It contended that shipping profit can be taxed only in Mauritius under Article 8 of treaty since its POEM lies in Mauritius
- Tribunal affirming following facts that that POEM of Taxpayer is in UAE
 - POEM is place where key commercial decision that is necessary for the business is taken or in substance the POEM will originally be a place where the most senior person or a group of person make its decision
 - Shareholders of taxpayer are UAE resident and other directors are on board only to satisfy conditions of Mauritius government
 - Indian agent was appointed on letter head showing UAE address. Letter from AO also originated from UAE
 - Aforesaid indicates though company was registered in Mauritius, but major policy decisions were taken at UAE

AB Holdings – Mauritius II*



- IRA alleged that POEM of Mau Co is in US and it is not eligible for treaty benefits
- AAR held that holding company could have a role to play in affairs of the subsidiary. The C&M was not in US but in Mauritius
 - Movements of the directors in and out of Mauritius could not alone conclude that control and management was not in Mauritius
 - Physical absence of one director in board meeting and his attendance through telephone or video conference from US was a valid communication
 - The other two directors of M1 were well qualified to engage in meaningful discussions and were involved in the decision making process
 - Investment holding companies such as M1, did not require huge offices/staff or incur multiple account expenses as opposed to manufacturing or trading companies

* 90 taxmann.com 177

Legislative guidance

Legislative guidance

- EM of FA 2015 proposed issuance of set of guiding principles to be followed in determination of POEM for the benefit of the taxpayers as well as tax administration
- Press release dated 24 January released providing turnover based exemption
- Post consultative process guiding principles released in form of Circular No 6 of 2017
- Being Circular following principles needs to be borne:
 - Circular being delegated legislature cannot usurp or expand scope of parent legislature
 - Circular is binding on tax authorities even if prejudicial to revenue interest
 - Circular is not binding on taxpayer
- Guidelines largely adopted from South Africa Revenue Service (SARS) Interpretation No 6 (Issue 2)

FA 2018 introduced Explanation 4 which provides that where the term is not defined in agreement but defined in Act, it shall have same meaning as assigned to it in the Act and explanation if any given to it by Central Government

Press release dated 24 January 2017

- ABOI test has been provided so as not to cover companies outside India which are engaged in active business
- The intent is not to target Indian MNC which are engaged in business activity outside India
- The intent is to target shell companies and companies which are created for retaining income outside India although real C&M of affairs is located in India
- Intend is not to cover foreign companies or to tax their global income merely on the ground of presence of PE or BC in India
- POEM guidelines shall not apply to companies having turnover or gross receipts of 50crs or less in financial year
- Circular No 8 of 2017 clarifies that section 6(3)(ii) shall not apply to small companies stated above
- Risk of fragmentation of turnover to number of companies
 - Risk of GAAR

Guiding principles

- Determination of POEM depends upon facts and circumstances of each case
- POEM concept is one of substance over form
- Entity may have more than one place of management, but it can have only one place of effective management at any point of time
- POEM will be required to be determined on year to year basis
- Guiding principles are not to be seen with reference to any particular moment in time rather activities performed over a period of time during the previous year needs to be considered
- If it is determined that during the previous year the POEM is in India and outside India then POEM shall be presumed to be in India if it has been mainly/predominantly in India

Irrelevant factors

- FCO is completely owned by ICO
- FCO PE exists in India
- One or some of the directors of foreign company reside in India will not be conclusive evidence that conditions for establishing POEM in India
- Local management being situated in India in respect of activities carried out by FCO in India will not be conclusive evidence by itself
- Existence in India of support functions that are preparatory and auxiliary in character will not by itself be conclusive evidence that conditions of POEM have been satisfied

Approach to POEM

Determination of POEM

```
graph TD; A[Determination of POEM] --> B[Companies engaged in Active Business Outside India (ABOI)]; A --> C[Companies other than those engaged in Active Business Outside India]; B --> D[POEM outside India if majority BOD Meetings outside India]; B --> E[However, if de facto decision making authority is not BOD but Indian parent or resident, POEM shall be in India]; C --> F[Stage 1: Identify the persons who actually make the key management and commercial decision]; C --> G[Stage 2: Determine the place where these decisions are in fact being made – important than the place where implemented];
```

Companies engaged in Active Business Outside India (ABOI)

- POEM outside India if majority BOD Meetings outside India
- However, if de facto decision making authority is not BOD but Indian parent or resident, POEM shall be in India

Companies other than those engaged in Active Business Outside India

Stage 1: Identify the persons who actually make the key management and commercial decision

Stage 2: Determine the place where these decisions are in fact being made – important than the place where implemented

Procedural safeguard



Before considering FCO POEM in India

- AO to seek prior approval of collegium of 3 members consisting of PCIT

Opportunity of being heard

- Collegium shall provide an opportunity of being heard
- Pass direction

- Unlike GAAR – panel consists of revenue members
- Not explicit requirement of providing copy of direction to assessee
- Possible to invoke writ jurisdiction since direction per se is not appealable?

ABOI test

ABOI test

Residency test

POEM of company engaged in ABOI is presumed to be outside India if majority meetings of BOD are held outside India – unless, BOD are not exercising powers

Meaning of ABOI

Passive income is more than 50% of total income

More than or equal to 50% of total assets are situated outside India

More than 50% of total number of employees are not situated in India or are not resident of India

Payroll expenditure on such employee is more than or equal to 50% of total payroll expenditure

- Aforesaid conditions needs to be cumulatively satisfied
- Average data of previous 3 years needs to be considered
- Essential to have board meeting even if laws of FCO has no such mandate

Passive Income

Passive Income

- Income transact transactions where both purchase and sale of goods is from/to its AE
- Income by way of
 - Royalty
 - Dividend
 - Capital gains
 - Interest
 - Rental income

- Interest income of company engaged in banking business or public financial institution excluded

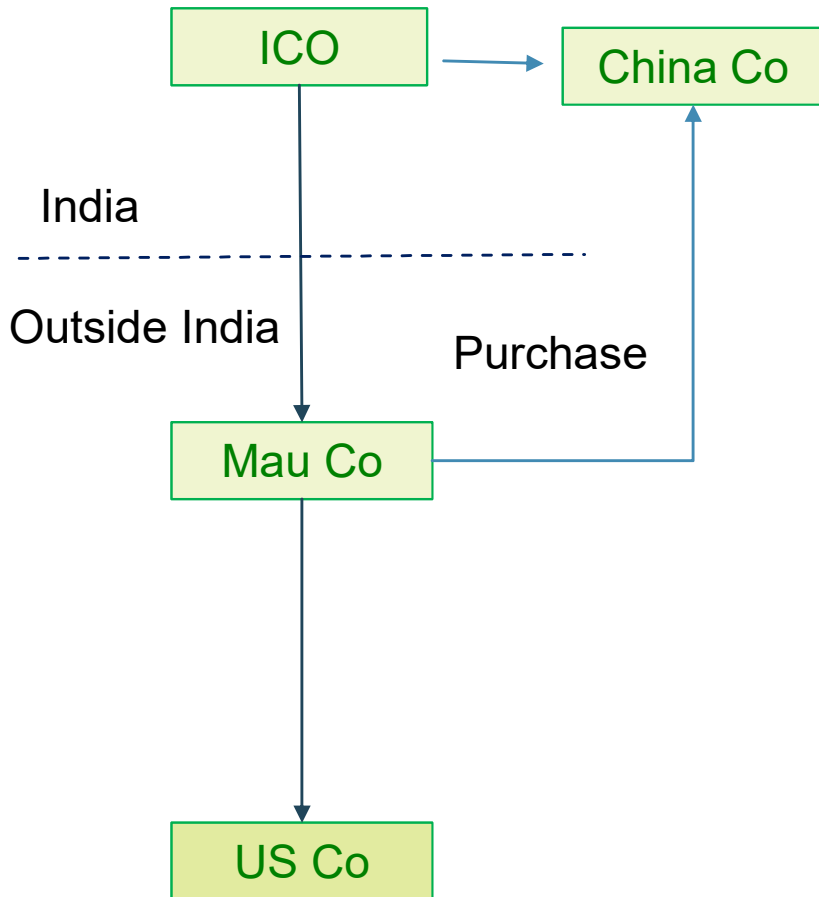
Income

- As computed for tax purpose in accordance with tax law of FCO
- Books of account – where laws of incorporation does not require computation

Issues

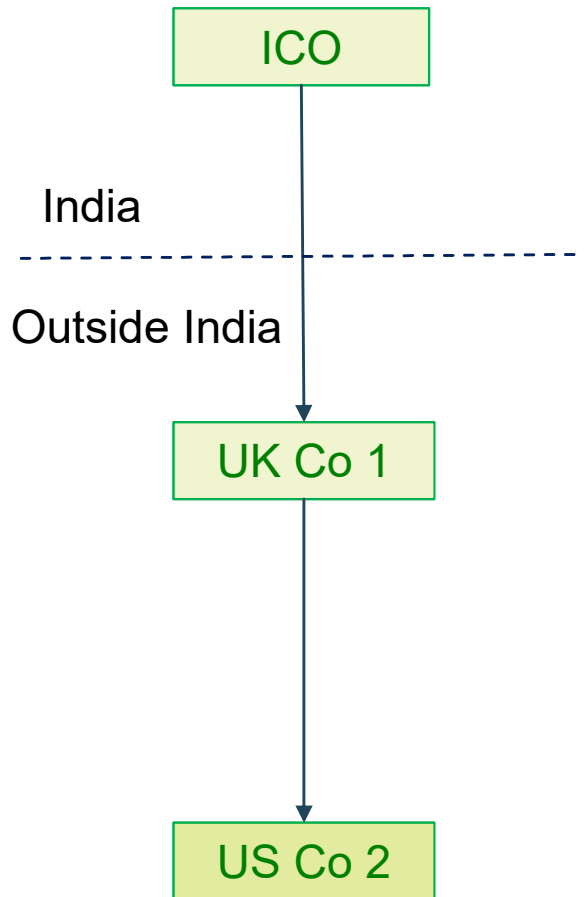
- Fictionally deems by buy-sell between AEs as passive income
- Average data of past 3 years needs to be considered
- Expanded definition of ITA to apply

Operating income from AE transactions



- Mau Co procures goods from China Co (AE) and sells the same to US Co
- All assets and employees are outside India
- Purpose of incorporation of Mau Co is free trade between US and Mauritius
- China and US Co has accepted transaction to be at ALP
- Since 100% of transaction of Mau Co is with AEs it fails ABOI test

Example 2: Impact of tax law



Facts:

- UK Co 1 purchases pharma drugs and sells to UK Co 2 who is low risk distributor
- Significant profit is parked in UK Co 1. Long term plan is to utilize profits to make brownfield acquisitions
- UK Co 1 opts for fiscal consolidation in UK and files return on consolidated basis

Issue:

- How to compute passive income ?

Value of asset

Value of asset

Individually depreciable asset

- Average value as per tax law

Pool of asset

- Average value as per tax law

Other asset

- Book value

- Method equally applicable to compute

India and outside India asset

- Average data of past 3 years needs to be considered

Issues

- Intangible assets not recorded in books?
- Value changed during audit by RA
- Computation to be done for FCO and assets of sister subsidiary – say engaged in manufacturing business in same jurisdiction cannot be considered
- Impact of revaluation of asset

Employees

Number of employees

- Average number of employees
- Includes those who perform tasks similar to those performed by employees

Payroll cost

- Cost of salaries, wages, bonus and all other employee compensation including related and social costs borne by the employer

Issues

- Meaning of employees situated in India
- Wide ambit of term 'those who perform tasks similar to those performed by employees' – stress on activities rather than work relationship with FCo
- Position of contractors working for number of group companies
- Position of regional head responsible for various countries
- Position of service line leaders

Average data computation

Para 7.2 of guidelines

The average of the data of the previous year and two years prior to that shall be taken into account

Possibility 1 – Aggregate approach

Income	Year 1	Year 2	Year 3	Total
Active Income	20	2	20	42
Passive Income	-	28	30	58
Total Income	20	30	50	100
Average	$58/100 = 58\%$			
ABOI test not met				

Average data computation

Para 7.2 of guidelines

The average of the data of the previous year and two years prior to that shall be taken into account

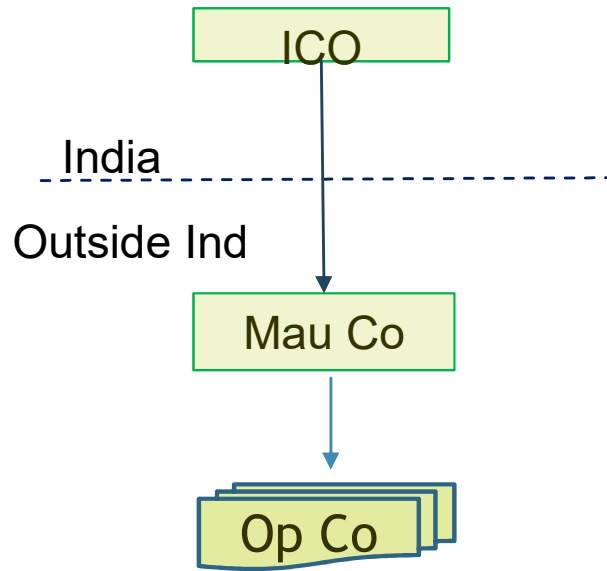
Possibility 2 – Yearly average

Income	Year 1	Year 2	Year 3	Total
Active Income	20	2	20	42
Passive Income	-	28	30	58
Total Income	20	30	50	100
Average	0%	90 % (28/30)	50% (30/50)	

Average of PI : $0 + 90 + 50 = 140/3 = 46.6$

ABOI test met

Impact on sale of investment



Facts:

- Mau Co is operating cum investment company
- Mau Co holds shares of various start up companies
- FY 17-18 – Mau Co sold shares of one of the company at huge valuation

Year	AI	PI	Total	% of PI
15-16	100	0	100	0
16-17	100	0	100	0
17-18	100	CG 5000	5100	98%
Average of 3 years				33

ABOI test met

Negative Income

Para 7.2 of guidelines

The average of the data of the previous year and two years prior to that shall be taken into account

Possibility 1 – Ignore negative

Income	Year 1	Year 2	Year 3	Total
Active Income	(20)	12	20	52
Passive Income	10	18	30	48
Total Income	10	30	50	100
Average	100 (10/10)	60 % (18/60)	50% (30/50)	

Average of PI : $0 + 60 + 50 = 110/3 = 36.6$

Negative Income

Para 7.2 of guidelines

The average of the data of the previous year and two years prior to that shall be taken into account

Possibility 2 – Consider negative

Income	Year 1	Year 2	Year 3	Total
Active Income	(20)	12	20	52
Passive Income	10	18	30	48
Total Income	10	30	50	100
Average	33 (10/30)	60 % (18/60)	50% (30/50)	

Average of PI : $33 + 60 + 50 = 143/3 = 47.6\%$

Tax exempt PI

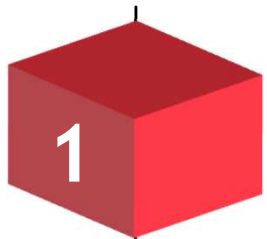
Meaning of Income

Income shall be as computed for tax purpose in accordance with the laws of incorporation

Income	Amount
Active Income	100
Exempt dividend income	100
Interest	50
Total Income for tax purpose	150
% of PI without considering exempt income	33% (50/150)
% of PI considering all income	60% (150/250)

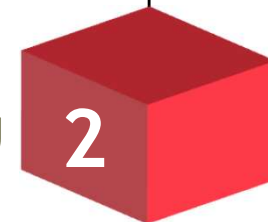
Non - ABOI test

Steps to determine POEM



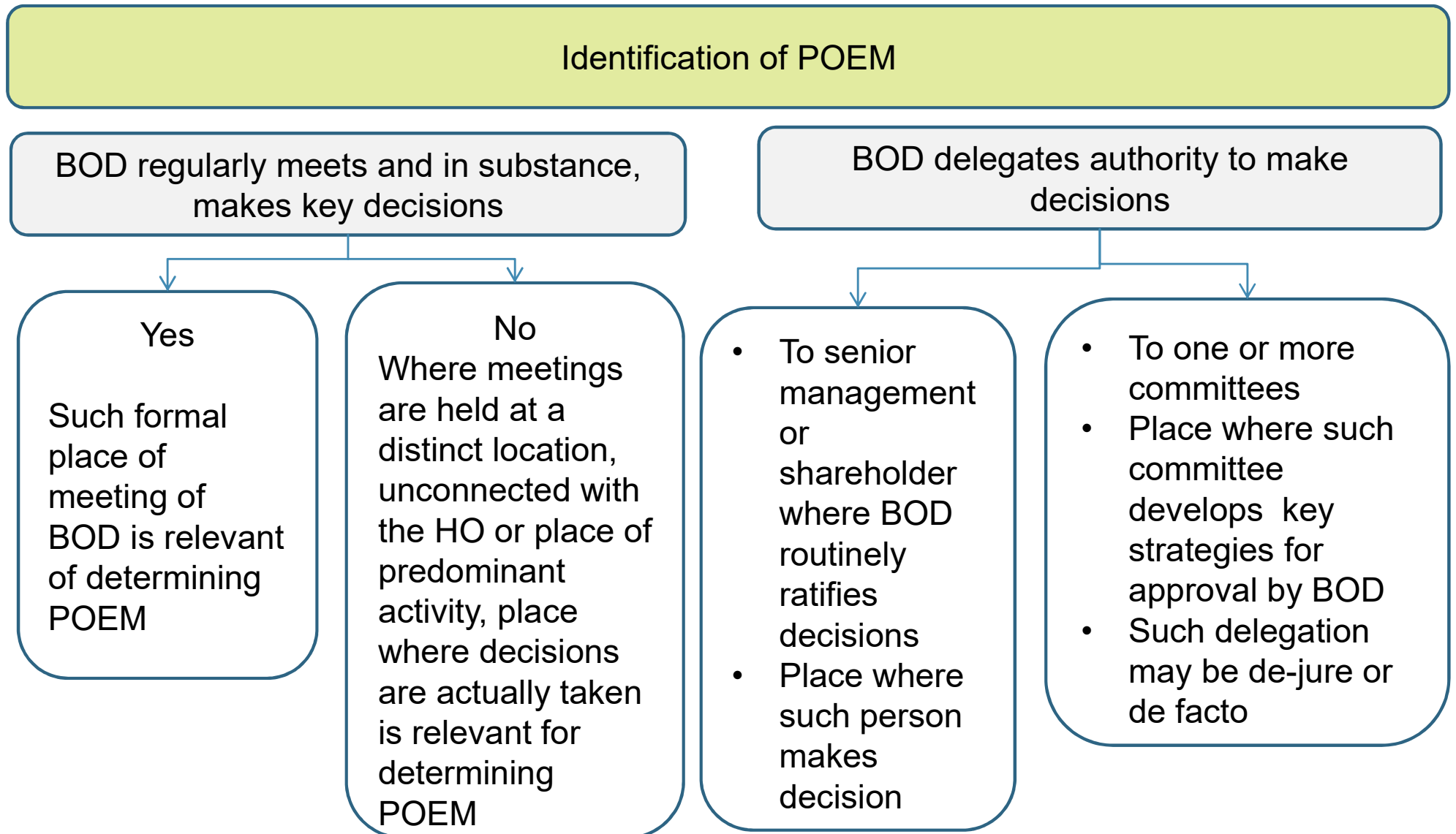
- Identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company business as a whole

- Determination of place where these decisions are in fact being made



Place where decisions are taken would be more important than the place where such decisions are implemented

Non - ABOI test (1/2)



Non - ABOI test (2/2)

Identification of POEM

Company HO

Single location

- Place where SM/DS are located

Multiple locations

- Where SM are predominantly based

Decentralized

- Not possible to determine POEM – HO not relevant

Modern technology

- Physical presence of person may not be required
- Place where directors/decision makers usually reside

Secondary factors

- Place where main/substantial activity of the company is carried
- Place where accounting records of company are kept

Shareholders influence

SC observations in Vodafone

- It is generally accepted that the group parent company is involved in giving principal guidance to group companies by providing general policy guidelines to group subsidiaries
- the fact that a parent company exercises shareholder's influence on its subsidiaries does not generally imply that the subsidiaries are to be deemed residents of the State in which the parent company resides
- Where the subsidiary's executive directors' competences are transferred to other persons/bodies or where the subsidiary's executive directors' **decision making has become fully subordinate to the Holding Company** with the consequence that the subsidiary's **executive directors are no more than puppets** then the turning point in respect of the subsidiary's place of residence comes about

Guidelines on shareholders influence

- Adherence to general and objective principles of global policy of the group laid down by parent does not mean BOD of companies are standing aside
 - Provided policies are not specific to entity or group of entity
- Policies may relate to payroll functions, accounting, human resource functions, IT infrastructure, supply chain functions, routine banking and operational procedures
- Shareholders involvement may result in POEM if shareholders limit the authority of board and senior managers of the company and thereby remove the company real authority to make decision
- In aforesaid situation, shareholder guidance transforms into usurpation and undue influence resulting into POEM in India
- Accordingly, whether shareholders involvement is crossing the line into POEM is one of fact and to be determined on case-to-case basis

Transitional provision

Transitional provision

- Computation of income of FCOs turning first time resident in India to be dealt with by section 115JH read with draft notification. Following manner of computation prescribed

Aspect of computation	Mechanism
Depreciation	<ul style="list-style-type: none">• Opening tax WDV if FCO is assessed to tax in foreign country• Opening book WDV in other cases
Past losses and UAD	<ul style="list-style-type: none">• Brought forward loss or UAD on first day of previous year as computed under tax laws• Brought forward loss or UAD on first day of previous year in other cases

- Tax withholding provisions applicable – in case of conflict withholding provision applicable to NR applies
- FCO entitled to relief or deduction of taxes paid in accordance with section 90/section 91
- Tax rate of 40% applicable

Thank You

Our Offices

MUMBAI

605, Zee Nayak, M.G. Road, Vile Parle (East),
Mumbai – 400 057

Email : bhaumik@bgss.co.in

Mobile No: +91 98339 15583

AHMEDABAD

402, Suyojan Tower, Hotel President Lane, CG
Road, Ahmedabad, - 380009

Email : saumya@bgss.co.in

Landline : +91 79 300 22 330

Mobile No: +91 90999 27783

