

A Taxing POEM

Place of Effective Management (POEM) – Emerging Issues and Concerns

V. Vikram, Advocate

Agenda

- Residence of a Company:
 - An Elegy to the “Good Old Days”
 - Finance Bill, 2015 : Cat among the pigeons
 - Evolution of POEM
 - Finance Act, 2015 : Final POEM
- The Model Convention Sonnet
- Poetic Justice : POEM Jurisprudence
- An Ode to Ambiguity : CBDT Draft Guidelines
- Oh Company! Where art thou? : Points to Ponder
- POEM: Emerging Patterns

Residence of a company: The 'Good Old Days'

- Section 6(3) of the Income-tax Act, 1961, prior to its amendment by the Finance Act, 2015 read as follows:

A company is said to be resident in India in any previous year, if—

(i) it is an Indian company ; or

*(ii) during that year, the control and management of its affairs is **situated wholly in India.***

Residence of a company: The 'Good Old Days'

- There has been little dispute regarding residence of a Company in India till date
- The phrases “during that year” “situated wholly in India” provided enough safety blanket for the taxpayer!
- Government felt it was being misused to create shell companies abroad which were really being controlled from India

Residence of a Company: Finance Bill, 2015 - Cat among the pigeons

- **Finance Bill, 2015** brought about a sea change:

“”“Following clause (3) shall be substituted for the existing clause (3) of section 6 by the Finance Act, 2015, w.e.f. 1-4-2016 :

(3) A company is said to be resident in India in any previous year, if,—

(i) it is an Indian company; or

*(ii) its place of effective management, **at any time in that year**, is in India.*

*Explanation.—For the purposes of this clause “place of effective management” means a place where **key management and commercial decisions** that are necessary for the conduct of the business of an entity as a whole are, in substance made.”””*

Evolution of POEM

Memorandum – Finance Bill 2015

“The existing provisions of section 6 of the Act provides for the conditions under which a person can be said to be resident in India for a previous year. In respect of a person being a company the conditions are contained in clause (3) of section 6 of the Act. Under the said clause, a company is said to be resident in India in any previous year, if- (i) it is an Indian company; or (ii) during that year, the control and management of its affairs is situated wholly in India....”

***“...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 has been rendered to be practically inapplicable. A company can easily avoid becoming a resident by simply holding a board meeting outside India. This facilitates 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 recognize 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.”

*The principle of POEM is recognized and accepted by Organisation of Economic Cooperation and Development (OECD) also. The OECD commentary on model convention provides definition of place of effective management to mean the place **where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made.** 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.*

*In view of the above, it is proposed to amend the provisions of section 6 to provide that a person being a company shall be said to be resident in India in any previous year, if- **(i) it is an Indian company; or (ii) its place of effective management, at any time in that year, is in India** . Further, it is proposed to define the place of effective management to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. Since POEM is an internationally well accepted concept, there are well recognised guiding principles for determination of POEM although it is a fact dependent exercise. However, it is proposed that in due course, a set of guiding principles to be followed in determination of POEM would be issued for the benefit of the taxpayers as well as, tax administration. These amendments will take effect from 1st April, 2016 and will, accordingly, apply in relation to the assessment year 2016-17 and subsequent assessment years.*

[Clause 4]

Evolution of POEM (contd.)

- Interesting side note: Concept of POEM for determination of residential status was introduced in Direct Taxes Code Bill (DTC) released on 15 June 2010. It survived with modifications in DTC revised draft circulated in 2013 (Section 4(b), 314(192))
- Cut & Paste from Malaysia?!
 - A company carrying on a trade or business is resident in Malaysia for the basis year for a year of assessment **if at any time during the basis year the management and control of its business or of any one of its businesses are exercised in Malaysia.**

Evolution of POEM (contd.)

- 2015 Finance Bill's phrase **“at any time in that year”** caused much hue and cry!
 - Rightly so. Even one Board meeting in India could cause this clause to be triggered!
- 2015 Finance Act watered down the wording to read:
 - “**Section 6 (3)** A company is said to be resident in India in any previous year, if –*
 - (i) it is an Indian company; or*
 - (ii) its place of effective management, in that year, is in India”*

Model Conventions on POEM

- OECD, UN and US Model Conventions all discuss tie-breaker rules for determining residence of individuals and other person's (which includes companies)
- OECD Model is what the Indian Finance Bill explanation refers to!
 - India doesn't officially follow the OECD Model – just copies whenever favourable? 😊

OECD MC

Article 4 - Resident

*“3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its **place of effective management is situated.**”*

Bottomline: OECD recognizes POEM as a tie breaker rule for determining residential status.

Commentary on OECD MC

- Commentary on OECD Article 4(3) observes that all relevant facts and circumstances must be examined to determine POEM.
- OECD suggests that in determining POEM, various factors should be taken into account including factors such as
 - where the Board Meetings are usually held;
 - where the Chief Executive Officer and other Senior Executives usually carry on their activities;
 - where the Senior day-to-day management of the person is usually carried on;
 - where the person's Headquarters are located;
 - which Country's law govern the legal status of the person; where its accounting records are kept;
 - whether determining that the legal person is a resident of one of the Contracting States but not of the other would carry the risk of an improper use of the Convention.

OECD on POEM

- **2014 OECD Base Erosion and Profit Shifting (BEPS) Action Point 6** mentions initially, it was considered that it would not be an adequate to attach importance to purely formal criterion like registration and preference was given to a rule based on the POEM, which was intended to be based on the place where the company is actually managed.
- However, in 2014, the Committee on Fiscal Affairs recognized that there had been a number of tax avoidance cases involving dual resident companies. **The BEPS report therefore concluded that a better solution to the issue of dual residence of entities was to deal with such situations on a case-by-case basis instead of having POEM as test.**
- **Shipping & Airline Articles:** The concept of POEM also appears in most of the tax treaties for determining taxability of shipping and airline entities and also as a tie breaker rule under Article for residence.

UN on POEM

*“3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its **place of effective management is situated**”*

- Similar to the OECD, the UN posits the use of a POEM as a tie-breaker rule in case of a person, other than individual, being resident of both Contracting States

UN on POEM

- India's Letter to the UN on its 2011 Model Convention update interestingly mentions the following:

“In addition to these, the Commentary needs to clarify that the place where main and substantial activity of the entity is carried on, should also to be taken into account when determining the place of effective management”

US Model Convention – Article 4(4)

*“4. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, **then if it is created or organized under the laws of one of the Contracting States or a political subdivision thereof, but not under the laws of the other Contracting State or a political subdivision thereof, such company shall be deemed to be a resident of the first mentioned Contracting State.** In all other cases involving dual resident companies, the competent authorities of the Contracting States shall endeavor to determine the mode of application of the Convention to such company. If the competent authorities do not reach such an agreement, that company will not be treated as a resident of either Contracting State for purposes of its claiming any benefits provided by the Convention. “*

USA Model Convention

Dual-Resident Tie-breaker

- Two dual-resident cases:
 - Company created as a resident of USA and controlled/managed in other State (say, India). Article 4(4) says incorporated in USA and POEM in India means tie-breaker will consider it as USA resident
 - Originally incorporated in one Contracting State but has "continued" into the other Contracting State. If First-mentioned Contracting State does not recognize the migration and continues to treat the company as a resident, then Competent Authorities have to determine. Failing which, no Treaty benefits

India-USA DTAA

*“3. Where, by reason of paragraph 1, a company is a resident of both Contracting States, **such company shall be considered to be outside the scope of this Convention** except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry into Force)”*

Klaus Vogel on POEM

- According to Klaus Vogel:
 - PoEM is the place where the management's important policies are actually made;
 - **What is decisive is not the place where the management directives take effect but rather the place where they are given**
 - The 'Centre of management' activities of a company generally is the place at which the person authorized to represent the Company carries on his business management activities;
 - A place from where the business is merely supervised would not qualify;
 - If the commercial and the non-commercial side of the business are managed at different places, the location of Commercial management is of significance
 - If the above criteria is inconclusive, then the top manager's residence will regularly determine the residence of the Company.

Poetic Justice : Jurisprudence

- Different countries follow different interpretations of POEM
- “Continental Model”
 - Where Senior Management of company operate
- “Anglo American Model” – Board-centric approach
 - Where Place where Board meets
 - India seems to prima facie follow this?
(surprisingly!)

POEM Jurisprudence

South Africa

- SA considers POEM based on the **second level management** i.e. the place where the company is managed on a regular or day to day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.
- It thus identifies POEM based on location of senior officers or executives who are responsible for
 - (i) actually developing or formulating key operational or commercial strategies and policies for, or taking decisions on key operational or commercial actions by the company and
 - (ii) ensuring that those strategies and policies are carried out.

POEM Jurisprudence

- Russia looks at any of the following conditions fulfilled for holding POEM in Russia:
 - If Majority of Board of Directors meetings are held in Russia
 - Executive body regularly carries out activities from Russia
 - CEO primarily carries out activities in the form of executive management from Russia

POEM Jurisprudence

China, France

- China defines effective management as substantial and overall management and control over manufacturing and business operations, human resources, accounting, properties, etc. of the entity.
- France, in its observations to OECD commentary, mentions POEM as *'the place where the person or group of persons who exercises the most senior functions (for example a board of directors or management board) makes its key management and commercial decisions, the place where the organs of direction, management and control of the entity are, in fact, mainly located.'*

POEM Jurisprudence

Hungary

- Hungary determines POEM based on:
 - Taking into account the place where the chief executive officer and other senior executives usually carry on their activities as well as the place where the senior day-to-day management of the enterprise is usually carried on.
- “Day-to-day management” is ignored by many countries, including India, when determining POEM!

POEM Jurisprudence

UK, Germany, Spain, Italy

- UK: Entities incorporated in UK or Centrally Managed and Controlled in UK
 - Generally understood to be where Head Office is
- Germany: Registered Office or PoM is in Germany, then POEM is Germany
 - Place where people who have final authority make their decisions
- Spain: Incorporated under Spanish laws or legal seat in Spain
- Italy: Registered office or legal seat, PoEM or main business purpose is in Italy for greater part of the year

POEM Jurisprudence

International case laws

- **Trevor Smallwood Trust - [2010] EWCA Civ 778 (UK)** : “One has to look at the place from where the real top level of management or realistic, positive management of the taxpayer, a trust, was exercised”
- **Wensleydale’s Settlement Trustees V. Inland Revenue Commissioners - [1996] STC 241 (UK)** : ‘Effective’ implies realistic, positive management. The PoEM is where the shots are called, to adopt a vivid transatlantic colloquialism
- **Laerstate BV v. The Comm. Of Her Majesty’s Revenue and Customs – SC 3032/07 (UK)** : “One needs to consider, whether a director acted on another person’s wishes or instructions without truly considering the merit of those wishes or instructions; or whether the director considered the wishes or instructions but still made the decision while in possession of the minimum information required to make a decision”
- **Switzerland Case - 2C-1086/2012, 2C-1087/2012** : “The PoEM would be where the economic and effective center of a company is located. The decisive factor is thus the management of daily business activities within the company's purpose; the place of board meetings or the general assembly is to be disregarded.”

CBDT Draft Guidelines

- CBDT issued Draft Guidelines on 23rd December 2015
- 12 para detailed Note inviting public comments till January 2nd 2016
- Clarity is welcome but it still leaves a number of questions unanswered
 - Enough caveats to cause concern for the taxpayer!

CBDT Draft Guidelines

1. General Guidance

- Process of determination of POEM would be:
 - Based on facts and circumstances
 - Substance over form
 - Based on place where decisions are taken rather than place where implemented
- **Day to day routine operations shall not be relevant for determination of POEM**
- *“Any determination of the PoEM will depend upon the facts and circumstances of a given case”*
- *“The PoEM concept is one of substance over form.”*

CBDT Draft Guidelines

2. Guidance for Companies engaged in “active business” outside India:

- Distinction between companies engaged in “active business” outside India and those who aren’t
- “Active business” outside India if:
 - Passive income does not exceed 50% of its total income
 - Passive income is aggregate of
 - » income of transactions where purchase/sale both is from/to its AE’s and
 - » Income by way of royalty, dividend, capital gain, interest or rental income
 - < 50% of total assets are in India
 - < 50% of total employees are situate / resident in India
 - Payroll on such employees is < 50% of payroll expenditure

CBDT Draft Guidelines

“Active Business” Test

- For the above “active business” test, the average of the data of the year and two years prior to that shall be considered. If the company has been in existence for a shorter period, then data of such period shall be considered.
 - Wait, what about initial year of operations of this provision! This is akin to retrospective operation?

CBDT Draft Guidelines

“Active Business outside India”

- **Bottomline: For a company engaged in active business outside India, its POEM will be presumed to be outside India if the majority of the meetings of the board of directors of the company are held outside India.**
 - However, if established that the Board are not exercising their powers of management, which are instead being exercised by either the holding company, or any other person resident in India, then the company’s POEM will be India.

CBDT Draft Guidelines

3. Guidance for companies not engaged in “active business” outside India

– For such companies, a **two-stage process for determination of their POEM:**

- Identifying or ascertaining the person or persons who actually make the key management and commercial decisions for the conduct of the company’s business as a whole
 - Determination of the place where these decisions are being taken
- Note, again, that place where decision taken is more important than where implemented

CBDT Draft Guidelines:

Flowchart for determining POEM!

- **Primary factors:**
 - **Location where Board meetings takes place**
 - If delegated, place where delegated Senior Management takes the decisions
 - **Location of ‘Head Office’**
 - Very important for POEM determination
 - Detailed definition provided
 - **When technology is used**
 - Place where Directors or persons taking decision or majority of them usually reside
- **Secondary factors:**
 - Place where substantial activity of company is carried out
 - Place where accounting records are kept

CBDT Draft Guidelines

Primary factors – Location of Board meeting

- POEM is where the Company's Board regularly meets provided it retains & exercises its authority to govern the company; and does, in substance, make the **key management and commercial decisions** necessary for the conduct of the company's business as a whole.
 - If key decisions by Directors are taken elsewhere other than place of formal meetings, then such other place would be relevant for POEM.
- If Board delegates (*de jure* or *de facto*) to "Senior Management" or any other person (including shareholder) then POEM will be where such persons make those decisions

CBDT Draft Guidelines

“Senior Management”

- (d) “Senior Management” in respect of a company means the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While designation may vary, these persons may include:
 - (i) Managing Director or Chief Executive Officer;
 - (ii) Financial Director or Chief Financial Officer;
 - (iii) Chief Operating Officer; and
 - (iv) The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

CBDT Draft Guidelines

Primary Factors - Location of “Head Office”

- “Head office” of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located.
- A company’s head office is not necessarily the same as the place where the majority of its employees work or where its Board typically meets;

CBDT Guidelines

“Head Office” flowchart

- Senior Management and support staff in one location – that location is kosher....err POEM!
- Company is decentralized:
 - HO is where Senior Managers are
 - primarily or predominantly based or
 - Normally return to travel to other locations or
 - Meet when formulating key decisions
- If in case of video-conferencing, HO would normally be location where highest level of management and their direct support staff are located
- If everything fails wrt HO, criteria of HO won't be used for POEM determination

CBDT Draft Guidelines:

When not 'automagically' a POEM

- A foreign company completely owned by an Indian company does not automatically posit a POEM
- Some Directors of a foreign company reside in India will not be conclusive evidence of POEM in India
- Local management in India in respect of activities carried out by foreign company by itself shouldn't trigger POEM
- Preparatory and auxiliary ie support functions in India will not automatically trigger POEM
- **Bottomline: *Phew***

CBDT Draft Guidelines

- **Safeguard?** In case the AO proposes to hold a company incorporated outside India to have PoEM in India, then, prior approval of Principal Commissioner or Commissioner will be required, who shall provide an opportunity of being heard to the company before deciding the matter

Oh Company! Where art thou?

Points to Ponder

- Foreign subsidiaries of Indian companies
- Indian Branches of foreign companies
- Board meeting of foreign companies held in India along with Indian subsidiary
- Indian Directors in foreign MNC's
- 1000's of SPV's created by Indian companies abroad for foreign projects/business or for investments
 - Managed from India as the key players are here. Will now be hit by POEM?

Bottomline: Draft Guidelines address some of these concerns but does it cover all possibilities, ensure certainty of no POEM in all such cases? Answer is NO

Points to Ponder:

Active Business Outside India (ABOI) Test

- ABOI Test should be linked to commercial activity rather than normative characterization of income?
- Income from genuine commercial transactions between AE's is out of purview of "passive income"?!?
- Payroll expenses in India should be less than 50% of such foreign company's payroll expenditure is an impractical comparison?
- If all employees stay outside of India but are tax residents of India in that year (come back within 180 days), it will be considered non-active business outside India

Points to Ponder

POEM = Lose Treaty Benefits?

- In some cases, India to lose Treaty benefits due to POEM?
 - Assume, company interpreted to be a POEM under new Indian Income Tax Act and also resident of USA based on incorporation
 - India-USA DTAA Article 3 says a company resident in both Contracting States such company shall be considered to be outside scope of convention

Points to Ponder

Tie-breaker in India's favour?!

- DTAA conundrum
 - With the new POEM law, suppose the Company is dual resident as per domestic laws of both countries
 - Tie-breaker rule applied : talks about “place of effective management” (POEM)
 - Not defined in the DTAA
 - Typically, Article 3(2) – when term not defined in DTAA, domestic law of country applying DTAA will help; hence Indian tax law!

Points to Ponder

POEM Suggestions to Govt.

- Safe harbor rules to be provisioned
 - No PoEM in India if foreign company incorporated in a jurisdiction with minimum tax base rate of 20% say
- Foreign company should be eligible to claim FTC if it is found resident in India on account of POEM
- Indian Income Tax Act to be applied only after POEM in India determined and confirmed under MAP of the tax treaty
- Transfer Pricing fiasco:
 - Don't apply SDT after POEM (double-whammy!)
 - Don't apply TP on POEM AE and group companies outside India!

Points to Ponder

POEM Suggestions to Taxpayer

- Foreign entity activity delineated clearly especially chain of command
- Foreign entity's place of business to ideally house Senior Management and Board Members who wield actual authority
- Board constitution to be thought out carefully
- Board of Director Meetings planned and held ideally outside India
- Delegation of powers to Senior Management at foreign entity place of business wherever practical
- Documentation to substantiate PoEM

Conclusion

POEM: Emerging Patterns

- Yet another “Substance” vs. “Form” fight?
 - “Piercing the corporate veil” takes many shapes
- Indian Government is determined to attribute to what/who they believe is the underlying cause or beneficiary, which is usually in India, so as to capture more of the tax pie:
 - Capital Gains (situs of assets in India)
 - FTS (accrued or arisen in India)
 - Royalty (satellite customers in India)
 - PoEM (effective management in India)
- Devil is in the details; while Draft Guidelines are commendable there remains a worrisome ambiguity
- **Bottomline:** Another battlefield gets ready with interpretative, subjective language of the provision(s) leading to maximum benefit of all involved except the taxpayer!

Thanks!

V.Vikram

vvikram@gmail.com

vvikram@saprlaw.com

<http://www.saprlaw.com>

Subbaraya Aiyar, Padmanabhan & Ramamani
Advocates