Place of Effective Management (PoEM)

Striking the right balance

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We will focus on:

• What is PoEM and how does it affect your business?

• Factors triggering PoEM and effective decision making;

• Recently introduced Draft Guiding Principles by CBDT for determination of PoEM;

• Maintaining documentation and other safeguards.
The erstwhile condition of residency led to:

- Avoid residency by simply holding a Board meeting outside India;
- Led to creation of shell companies outside India especially in tax havens / low tax jurisdiction;

- PoEM is an internationally recognized residency concept adopted in tie-breaker Rule of treaties;
- It is recognised by OECD;
- It is a fact dependent exercise.
Background

Tax Residential Status

• Every jurisdiction has its own test of residence.

• Scope of taxable income depends upon a taxpayer’s residential status.

• Different Jurisdiction: Different yardsticks

• Not a static concept.

• Needs to be reviewed every year.
Section 6 of the Income Tax Act, 1961 - Residence in India

For the purposes of this Act, — .....  

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, 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.
## Key tests to remember...

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PoEM exists where:

• **Key Management** and **commercial decisions**, necessary for the conduct of entity’s business **as a whole**, are **in substance**, made.

**Lets look at each important concept here:**

• **Key:**
  • Key persons who actually manage the company to be considered;
  • Place from where key managerial persons actually conduct their management functions to be considered as PoEM

**Dictionary meaning**
Of central importance; a key figure; a vital element; strategic.
**Management Decisions:**

- Place from where important management decisions are taken is to be considered.

- Place from where decisions about day-to-day operations and business transactions are taken shall not be considered as PoEM in isolation.

*Dictionary meaning*

- the act of managing by direction or regulation, or administration;

- the management of a family, or of a household, or of servants, or of great enterprises, or of great affairs.
• **Commercial Decisions:**

  - The company having an office who may be doing the secretarial function of complying with the regulations not considered as PoEM.

  - Place where the Key Management takes important commercial decisions is the place where PoEM is situated.

*Dictionary meaning*

*From the point of view of profit; having profit as the primary aim, sacrificing artistic principles for qualities that bring financial success.*
The term ‘key’, ‘management’ and ‘commercial’ are cumulative and cannot be seen in isolation.

**Illustrations of management decisions:**

- Approving business plans and business strategy
- Appointment / Termination of key management personnel and their remuneration;
- Organizational reporting structure and key organization / management policy decisions;
- Code of Conduct, Group ethos and Ethics;
- Global IT systems policy and MIS reporting;
- M&A and company restructuring decisions, including divestment;
- Common procurement or sourcing for the group, including master agreements.
Interpretation

• **Illustrations of commercial decisions:**
  - Sourcing of Raw Materials, selection of distributors and its quality control;
  - Procedure and manner in relation to negotiations/execution of contracts;
  - Borrowings, Debt Financing, Capital Sourcing;
  - Product portfolio, methods of manufacture;
  - Pricing of products and services;
  - Expansion and modernization;
  - Accounting policies, R&D, Brand / patents registration (licenses).
Interpretation

- **Necessary for conduct of the business**
  
  - What are the management and commercial decisions necessary for conduct of business of an entity?

- **Of an entity as a whole:**
  
  - Different offices of an entity taking commercial and operational decisions restricted to its own area of work will not determine PoEM.

  - No piecemeal intra-unit/branch/division decisions – only those decisions that impact the entity as a whole
Interpretation

• **In Substance:**
  - Where is the real decision making happening?
  - Correct criteria is where decisions are, in substance made
  - Mere formality of deciding by the BOD in another country will not be PoEM.

  *Dictionary meaning of substance*
  
  *In essence; the material or essential part of a thing, as distinguished from ‘form’.*

• **Made:**
  - Actual implementation

  *Dictionary meaning*

  *Cause to exist or happen; bring about; to establish or enact; put into existence.*
Factors triggering PoEM

- **OECD MC** provides following factors:
  - The place where the actions to be taken by the entity as a whole are determined
  - Place where majority of the board of directors or equivalent body usually meet
  - Location of and functions performed at head-quarters of the entity
  - The place where the chief executive officer and other senior executives usually carry on their activities
  - Corporate books are located
Draft Guiding Principles for determination of PoEM

Draft guiding principles released by CBDT on December 23, 2015:

• Emphasizes that the concept of PoEM is one of **Substance over Form** and will depend on facts and circumstances of each case;

• Lays down that a company can have more than one place of management but it can have only one place of **effective** management;

• Contemplates different tests for determining PoEM of a company depending upon ‘active businesses outside India’ and companies not engaged in active businesses outside India.
Determining active business outside India:

1. **Passive income <= 50% of total income**
   - Yes
   - **Assets in India < 50% of total assets**
     - Yes
     - **Employees situated or resident in India < 50% of total employees**
       - Yes
       - **Payroll expenditure on such employees < 50% of total payroll expenditure**
         - Yes
         - **Active business outside India**
   - No
   - **Passive income <= 50% of total income**
     - No

If none of the above conditions are met, there is no active business outside India.
Determination of active business outside India

Tests for determining PoEM

Active Companies

Presumed to be outside India if majority of board meetings are held outside India.

Determination to be based on data over the past 3 years or less if the company has been in existence for a lesser period.

Companies other than those engaged in active business outside India

1st Stage – Identify persons who actually make key management and commercial decisions for the business as a whole.

2nd Stage – Determination of the place where these decisions are actually made.
The following guiding principles would be considered while determining the PoEM of a company:

• **Location where the Board regularly meets** and in substance takes key management and commercial decisions;

• Where the **Board routinely ratifies decisions** - taken by any other person - the place where such person takes decisions;

• **Location of a company’s head office** – different situations;

• **Day to day routine operational activities** of junior or middle management – not relevant
Factors to be considered for determination of PoEM

• No physical location of meeting - place of residence of majority of directors or decision making persons;

• Secondary factors:
  - place of main and substantial activity of the company; and
  - place where accounting records are maintained

• Foreign investment by an Indian company:
  - residence of some directors of the foreign company in India;
  - location of local management of foreign company in India; and
  - existence of support functions of preparatory or auxiliary character in India.
Factors to be considered for determination of PoEM

• Principles are only for guidance and not conclusive.

• Activities performed over a period of time during a financial year to be considered rather than a ‘snap shot’ approach.

Procedural aspect:
• 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.
Issues with Draft Guiding Principles for determination of PoEM

- Released around 9 months after the effective date of applicability of PoEM, India’s new test of corporate residence, the draft guiding principles have only increased the uncertainties.
- Several Indian MNC’s and foreign companies are now put in a dilemma on an issue as fundamental as corporate tax residence.
- PoEM may result in double taxation since it is an unilateral approach and there is no guarantee that the other country will accept the determination of a company’s PoEM in India since the concept of PoEM is not recognized by many tax treaties. One such treaty would be the India-US Double Tax Avoidance Agreement. This may increase the risk of Indian entrepreneurs who have operations in the US.
- Burden of proof on taxpayer.
Issues with Draft Guiding Principles for determination of PoEM

• With the implementation of PoEM there would be further incentive for Indian companies to relocate the founders and the top level management overseas to avoid the PoEM of the foreign subsidiary in India. This would result in increase brain drain from India.

• The current version of the guidelines would also defeat the “make in India” initiative of the Government since the subjective rules make it more difficult to do business in India.

• The concept of PoEM has replaced a settled decades old rule for corporate tax residence which would now increase in subjectivity and litigation risks for the organizations.

• Separate rules to counter abusive cross border structures such as CFC Rules.

• Cost of enforcement and information collection for tax authorities.
Consequences of Foreign company becoming Indian resident

- Liable to file Income Tax Returns
- Liability to maintain books of account and get the accounts audited
- Subject to Tax Audit and Transfer Pricing Audit regulations, if exceeding the prescribed threshold
- Compliance with TDS requirements and statutory filing obligations
- Liable to pay Advance Tax and Self-assessment Tax
PoEM and Domestic Transfer Pricing

• Transactions between entities treated as “Indian Resident” due to PoEM and other related Indian entity may lead to applicability of Domestic Transfer Pricing Regulations.

• Lead to problems of maintaining documentation, report filing, etc.

• Also, other challenges may arise if any transaction is contested during the Income tax assessment proceedings.
PoEM and International Transfer Pricing

• Transaction between foreign entities of same group company shall lead to applicability of International Transfer Pricing Regulations if one of the foreign entity is treated as resident of India due to PoEM.

• Liability of filing Transfer Pricing Audit Report, irrespective of the quantum of transaction.

• Liability of maintaining documentation in respect of each and every transaction.
PoEM and BEPS

- Most important concern of Base Erosion and Profit Shifting (BEPS) – is treaty abuse i.e. treaty shopping.

- Prevention of treaty abuse addressed by BEPS Action Plan 6 titled “Prevent Treaty Abuse”

- Action plan 6 proposes to
  - replace Article 4(3) of OECD Model Convention (PoEM) by “Competent Authority Rule”.

Implications:
Different competent authorities may, under the influence of domestic culture and thoughts, introduce different tests and yardsticks.
Decision making: *de facto* dominant over *de jure*

- Actual conduct is relevant and implicit in evaluation of PoEM.
- Emphasis on “actual state of affairs”
- *What matters is actual control and management (de facto) and not power or capacity to manage and control (de jure)*
Factors relevant for appraising *de facto* decision making

- **Collateral Evidences**
  - Social Media (e.g. LinkedIn) profiles of key employees;
  - Visiting Cards of employees showing their designation;
  - Attendance record of the meeting;
  - Location of the directors and their registered addresses.
• Incorporated in strategic locations or in the locations of the operating joint ventures or subsidiaries for commercial reasons.

• Factors to be considered for determining PoEM:
  
  ▪ Whether key decisions, which are germane to the role of SPV are taken by management of SPV?

  ▪ Examine the place from where SPV conducts itself, post formation.

  ▪ Whether parent company has laid down strict parameters which affects the independence of management of SPV?
Captive Subsidiaries

• Wholly owned subsidiaries of an entity established for performing a particular service and does not have any independence to operate on its own.

• Factors to be considered for determining PoEM:
  
  ▪ Whether key decisions, which are relevant to business model of captive subsidiary are taken by BOD of the company?
  
  ▪ In case of low risk routine function captive subsidiary
    ▪ Conduct of operations in the overseas jurisdiction.
    ▪ Evidences of key decisions being taken by the board
Health check for relative comfort

• Whether the charter documents recognize the authority of BOD?

• Directors of the company should be competent and independent;

• Keep track on powers delegated to MD / ED;

• The overall conduct should bring out that the BOD has the ability to cater to business needs of the company.

• Secretarial, accounting and corporate records should be available in the country of residence;

• Transactions between parent and subsidiary or group companies should be strictly at ALP.
Health check for relative comfort

• In case of outbound investment, presence of senior level employee in the operating jurisdiction on BOD;

• In case of outbound structure, it helps if there are business assets and operations in the jurisdiction;

• Discussions, debates, background justification documents and minutes should be well documented;

• Parental control may be limited to statutory matters.
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Consider these…

Place your management effectively now!

• Assessing potential factors triggering PoEM;
• Assist in the implementation of viable solutions;
• Review effectiveness of implementation on an on-going basis;
• Take recommendations from Tax Advisors to mitigate risks;
• Focus on documentation;
• Have an yearly PoEM audit.

Get a PoEM Impact Study done today!