



A NEW TAXATION REGIME- PLACE OF EFFECTIVE MANAGEMENT (POEM) OF FOREIGN COMPANIES SITUATED OUTSIDE INDIA

Introduction

With Finance Act 2015, the Indian Government has effectively tried to curb the situation of revenue loss caused by various Multi National Corporations by shifting their residential status to outside India. The Finance Act, 2015 brought about a paradigm shift in the criteria for determining tax residential status for foreign companies. The Government has introduced the concept of Place of Effective Management which has been accepted globally. This article highlights the effect of amendment in determining the residential status of foreign companies situated outside India and offer a close look at the Notification issued for implementation of POEM based taxation.

Pre-amendment position:

The earlier provisions Section 6 of Income Tax Act 1961, 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

Accordingly, for a company to be classified as resident in India, has to pass through two test, one based on its incorporation and other based on its management.

Post-amendment position:

As per amendment provided of section 6(3) of the Income-tax Act, 1961 (IT Act), a company is said to be resident of 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.

POEM is defined as "a place where key managerial and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in substance made."

A new Chapter XII-BC consisting of section 115JH was also inserted into the IT Act vide Finance Act, 2016, as per which the provisions of the IT Act relating to computation of total income, treatment of unabsorbed depreciation, set off and carry forward and set off of losses etc. shall apply to foreign companies having POEM in India subject to such exceptions, modification and adaptations as may be notified.

Date of Applicability:

India introduced the place of effective management (POEM) in its domestic law in Finance Bill of 2015 but to reduce the hardship to the companies by providing additional time it was deferred to April 1, 2017 and made applicable from assessment year 2017-2018.

The CBDT has further clarified that POEM provisions, deeming a foreign company as resident in India, shall **not apply to a company having turnover or gross receipts of Rs. 50 crores or less in a financial year.**

The final guidelines reiterate that determination of POEM is a substance over form issue and is to be determined on year-to-year basis.

Objective behind POEM based residency rule:

The earlier condition of residency required that whole of control and management should be situated in India and that too for whole of the year. This created an opportunity for various companies to avoid becoming resident by simply holding isolated events of management outside India. This facilitated creation of shell companies outside India which were virtually controlled and managed from India.

This caused the law makers to look up for an alternative in order to curb this practice and with this came the emergence of concept of POEM based residence rule in India.

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 recognizes the concept of POEM for determination of residence of a company as a tie-breaker rule for avoidance of double taxation.

Determination of POEM-Guidelines:

The Ministry of Finance vide its circular no 06 of 2017 dated 24th January 2017 have provided the guiding principles for determination of POEM of company.

- Active Business test: The guidelines prescribe that a company shall be said to engaged in 'active business outside India' if passive income is not more than 50% of its total income and
 - i. Less than 50% of its total assets are situated in India; and
 - ii. Less than 50% of total number of employees are situated in India or are resident in India; and
 - iii. The payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

POEM of a company engaged in active business shall be presumed to be outside India if the majority of the board meeting are held outside India. However, in case the Board is not exercising its powers of management and such powers are being exercised by any other person resident in India, including holding company, then POEM shall be considered to be in India. This is in consonance with substance over form.

The final guidelines have clarified that mere following of global policies laid down by the Indian holding company would not constitute that Board is standing aside.

For the purpose of determining whether the company is engaged in active business outside India, the average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such period shall be considered.

- **If No active business outside India:** the final guidelines provide a two stage process for determination of POEM in case of companies not engaged in active business. The first stage is identifying the person(s) who actually make the key management and commercial decisions for the conduct of the company's as a whole. As the second step, determine the place where these decisions are, in fact, being made.

Other guiding principles:

- i. The location where the Board of Directors meet and makes decisions may be the place of effective management of a company. However, in order to construe the same, the Board must actually have an authority and should in substance exercise its authority to govern the company. Further, mere holding of Board meetings is not sufficient. The place where the key decisions are taken is the decisive factor.
- Often physical board meetings are not necessary. Such meetings are done via technology. In such a scenario the location where the majority of the directors or persons taking decisions usually reside may be a relevant factor.
- iii. In case of delegation of authority to make the key management and commercial decisions to a person including shareholder, promoter, advisor, etc, or to a Committee, the place of effective management shall be the place where such people make those decisions or the location where such members of the committee are based.
- iv. Location of head office: The final guidelines provide that location of company's head office is important for determination of its POEM. Head office is defined as 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. In case the Company is more decentralized than the Company's head office would be the location where the senior managers normally return to following traveling to other locations or meet when formulating key strategies and policies for the company. Where meeting's are done via telephone or video-conferencing rather than physical meetings, the head office would be the location where the highest level of management, like Managing Director and their direct support staff, are located.
- v. The final guidelines have clarified that shareholder's decision making on matters reserved for them under the relevant company laws is not relevant for determination of POEM. A few examples of such decisions may be regarding sale of all or substantially all assets of the company, liquidation or de-registration of the company, issue of new class of shares, etc.
- vi. The final guidelines further provide that day-to-day routine operational decisions shall not be relevant. For example, decisions by the local plant manager concerning repairs and maintenance, implementation of company policies would be routine in nature.

If the above factors do not lead to clear identification of POEM then the final guidelines provide that following secondary factors may be considered:

- i. Place where main and substantial activity of the company is carried out; or
- ii. Place where the accounting records of the company are kept.

Apart from the above circular, CBDT has notified various other guidelines for the effective implementation of POEM based residency rule. It has also been notified that the Foreign Companies upon becoming a POEM-resident in India, shall be taxed @ 40% which is the rate applicable to any other foreign company and shall be entitled to relief from double taxation as per Double Taxation Avoidance agreement, if any.

Impact of Poem:

1. The Foreign Subsidiaries / JV's will become a Resident Company in India.
 - Tax on Global Income at the rate of 40% plus surcharge and cess.
2. Withholding Tax Implications in the hands of Foreign Companies in India.
3. Transfer Pricing Implication

Conclusion:

It is ample clear that the above principles for determining the POEM are for guidance only. No single principle will be decisive in itself. The above 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, need to be considered. In other words a "snapshot" approach is not to be adopted.

The introduction of POEM based residency rule is a welcome move and will surely lead to bringing the income of the foreign companies, incorporated outside India, which are being managed from India under the tax brackets. The back to back notifications and circulars brought down by the government shows that the government is keen to bring more and more clarity in order to reduce the litigation by the companies and move forward to a more globalized economy.

How Inmacs can Help:

Assisting in identification of Applicability of the POEM Regulation and Implementation of a solution.

- Understanding the company structure
- Details of Transactions
- Review of Delegation matrix for all commercials & business decision
- Composition of Board of Directors.
- Evaluation of all facts.
- Recommendations.
- Implementation of Recommendations.

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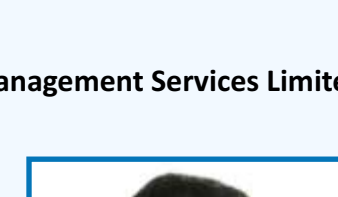
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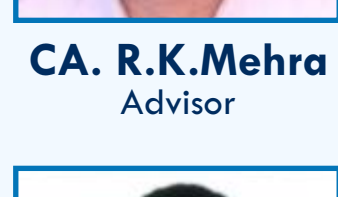
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Our People are Our Strength

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