



Western India Regional Council of ICAI

Seminar on Anti-avoidance Provisions relating to Income Tax

Concept of Place of Effective Management under ITA

CA Pinakin Desai

15 July 2017

Background and Introduction



Amendment to corporate residency by Finance Act (FA) 2015 and 2016

- ▶ Every country has a test of residency in its tax law. This could be based on factors such as:
 - ▶ Place of incorporation (e.g. USA) or
 - ▶ Place of control and management (C&M) (e.g.: Canada, Australia, UK)
- ▶ Pre-2015 corporate residency test in Section (S.) 6(3) of the Income Tax Act, 1961 (ITA), other than Indian company:
 - ▶ During that year, the control and management of its affairs is situated **wholly** in India
- ▶ FA 2015 as amended subsequently by FA 2016, w.e.f. AY 2017-18, a company, if not an Indian company resident in India if:
 - ▶ Its **Place of Effective Management (POEM)**, during that year, is in India

Amendment to corporate residency by Finance Act (FA) 2015 and 2016 (cont.)

- ▶ The Explanatory memorandum (EM) rationalises the amendment as:
 - ▶ Present condition of 'whole' C&M in India is too strict and practically inapplicable;
 - ▶ Facilitates creation of shell companies outside India while C&M is from India
- ▶ Press Release: Intent is not to target business entities but shell entities created for retaining income outside India.

Layman perspective:

- Is FCo. a puppet of ICo. headquarter (HQ)?
- Are strings of FCo. fully controlled from India?
- Does FCo. at all demonstrate any independence in terms of decision making?

Procedural safety net: Two stage approval process to invoke POEM

Stage 1

- Approval of Principal Commissioner/Commissioner of Income Tax before AO initiates POEM proceedings

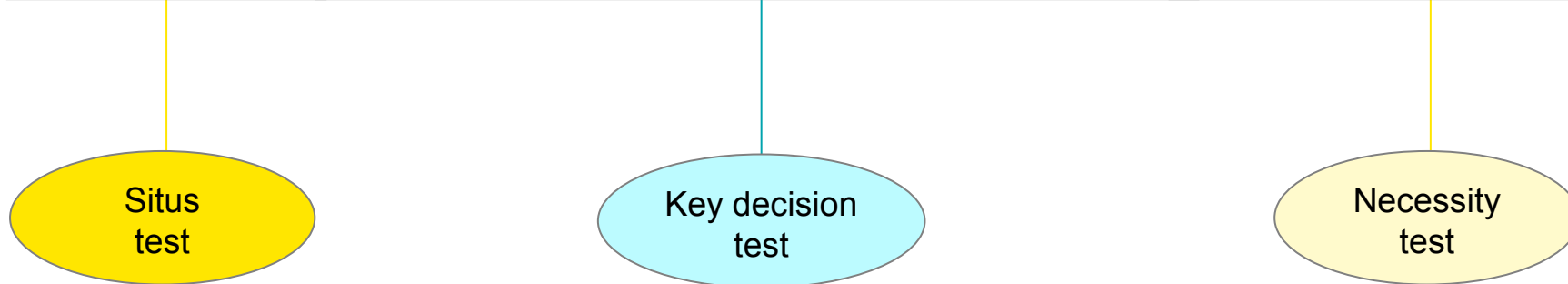
Stage 2

- Prior approval of collegium of three members consisting of Principal Commissioner/ Commissioners to be sought before holding POEM of a company to be in India

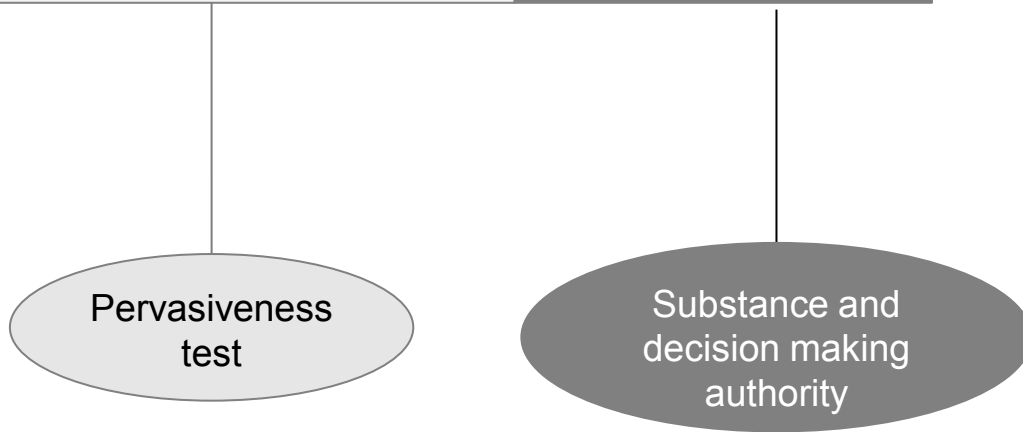
- ▶ 115JH: Power to CBDT to notify manner of applying ITA for the first time.
 - ▶ Draft Notification which was open for comments from stakeholders;
 - ▶ Notification once finalized to be made effective from 1 April 2017

POEM definition - Explanation to S.6(3)

“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.



Adverse consequences of trigger of POEM: *Illustrative list*

- ▶ Taxation of global income at the higher tax rate of 40%
- ▶ Non-entitlement to tax treaties; denial of FTC (eg. USA)
- ▶ Withholding of taxes continue under wider tax net of s.195
- ▶ Filing of ROI and trigger of domestic/ international transfer pricing
- ▶ Denial of carry forward of past losses due to non-filing of ROI

A closer look for better understanding



Control and Management

Indian guidance and jurisprudence

**Kanga,
Palkhivala
and Vyas¹**

As a rule, the direction, management and control, “the head and seat and directing power” of a company’s affairs is situated at the place where the directors’ meetings are held and consequently a company would be resident in this country if the meetings of directors who manage and control the business are held here

**SC in Nandlal
Gandalal²**

The head and brain of a company is the Board of Directors, and if the Board of Directors exercise complete local control, then the company is also deemed to be resident

¹ Volume I Edition Tenth

² (1960)(40 ITR 1)(SC)

Close knit Board v. Diverse Board

Case Study I:

- ▶ FCo. is a Mauritius company
- ▶ Only 2 directors of FCo. are spouses (or, two executives at India HQ) resident in India
- ▶ All BOD meetings of FCo. are held at Mauritius
- ▶ Indian Directors travel to Mauritius to attend meeting

Likely inference that decisions already taken in India – whether travel to Mauritius for Board meeting merely a formality?

Close knit Board v. Diverse Board

Case Study II:

- ▶ FCo. is a US company
- ▶ Board of FCo. comprises of 4 directors:
 - ▶ 1 Indian director
 - ▶ US attorney
 - ▶ CFO: Resident of US
 - ▶ 1 UK director
- ▶ **Scenario 1:**

BOD meetings of FCo. are held at US and all directors physically attend BOD meeting
- ▶ **Scenario 2:**

Indian director and UK director frequently travel and attend BOD meeting via video conferencing from the place where they are at the time of BOD meeting

What decisions lead to effective management?

Key

- Something of central importance;
- 'Strategic' - something of vital significance;
- Alignment with role and functions of the company.

Commercial

- From the point of view of profit;
- Having profit as the primary aim

Management

- The act of managing by direction, regulation, or administration

'And'

- Decisions must be commercial 'and' managerial in nature: Cumulative conditions

Illustrations of 'key commercial and management decisions'

'Managerial' decisions:

- ▶ Appointment/ termination of key personnel
- ▶ Organizational reporting structure (decision approval matrix, etc.)
- ▶ Periodical Assessment of SWOT
- ▶ Management Information System (MIS) reporting and its circulation

'Commercial' decisions:

- ▶ Mergers and Acquisitions (M&A), Growth strategies and decisions
- ▶ Expansion / modernization decisions
- ▶ Pricing strategy of products / services and market penetration strategy
- ▶ Review of cash flow and financial statements
- ▶ Capital gearing and debt financing related decisions

Illustrations of what are **not** 'key commercial and management decisions'

'Managerial' decisions:

- ▶ Payroll, timesheets or routine banking operations
- ▶ Accounting principles and policies, books of accounts

'Commercial' decisions:

- ▶ Adherence to contractual terms
- ▶ Decision of plant manager to run a facility, and carry on repairs and maintenance
- ▶ Statutory compliances

POEM outside India – Favorable factors

- ▶ Presence of active business outside India – ABOI test
- ▶ High tax jurisdiction – Motive test
- ▶ Self-propelled, infrastructure and employee strength
- ▶ History of C&M with unrelated group prior to acquisition
- ▶ Majority of directors and meetings outside India
- ▶ Independence / competence / involvement of directors
- ▶ Delegation of Authority (DOA) matrix leans in favour of personnel outside India – preferably, non-India controlled personnel

POEM outside India – Unfavorable factors

- ▶ Control over, and instructions to, the directors or senior personnel
- ▶ Delegation of authority and reporting matrix and actual conduct needs review
- ▶ Deep involvement on customer approval, pricing, discount (if substantial and commercial purpose not discernible)
- ▶ Non holding of board meetings; inadequate record of board meetings
- ▶ Intervention in day to day management and decision making
- ▶ Elaborate reporting of data to HQ in India for approval

Guidelines for determination of POEM

-issued by CBDT on 24 January 2017



Press Release dated 24 January 2017: De minimus threshold

- ▶ Press Release issued by CBDT introducing final POEM Guidelines
- ▶ Exclusion from applicability of POEM Guidelines to companies having turnover/gross receipts \leq INR 50 crores in a financial year
 - ▶ Subsequent CBDT Circular confirms non applicability of s. 6(3) to small companies
 - ▶ Principal Commissioner may deny approval for small companies
 - ▶ Each small foreign company to be evaluated on independent basis for 50 cr. Threshold
- ▶ Turnover limit applied qua entity: no anti fragmentation rule:
 - ▶ Risk of GAAR trigger in case of artificial split?
 - ▶ Risk of POM PE

General Principles in Guidelines

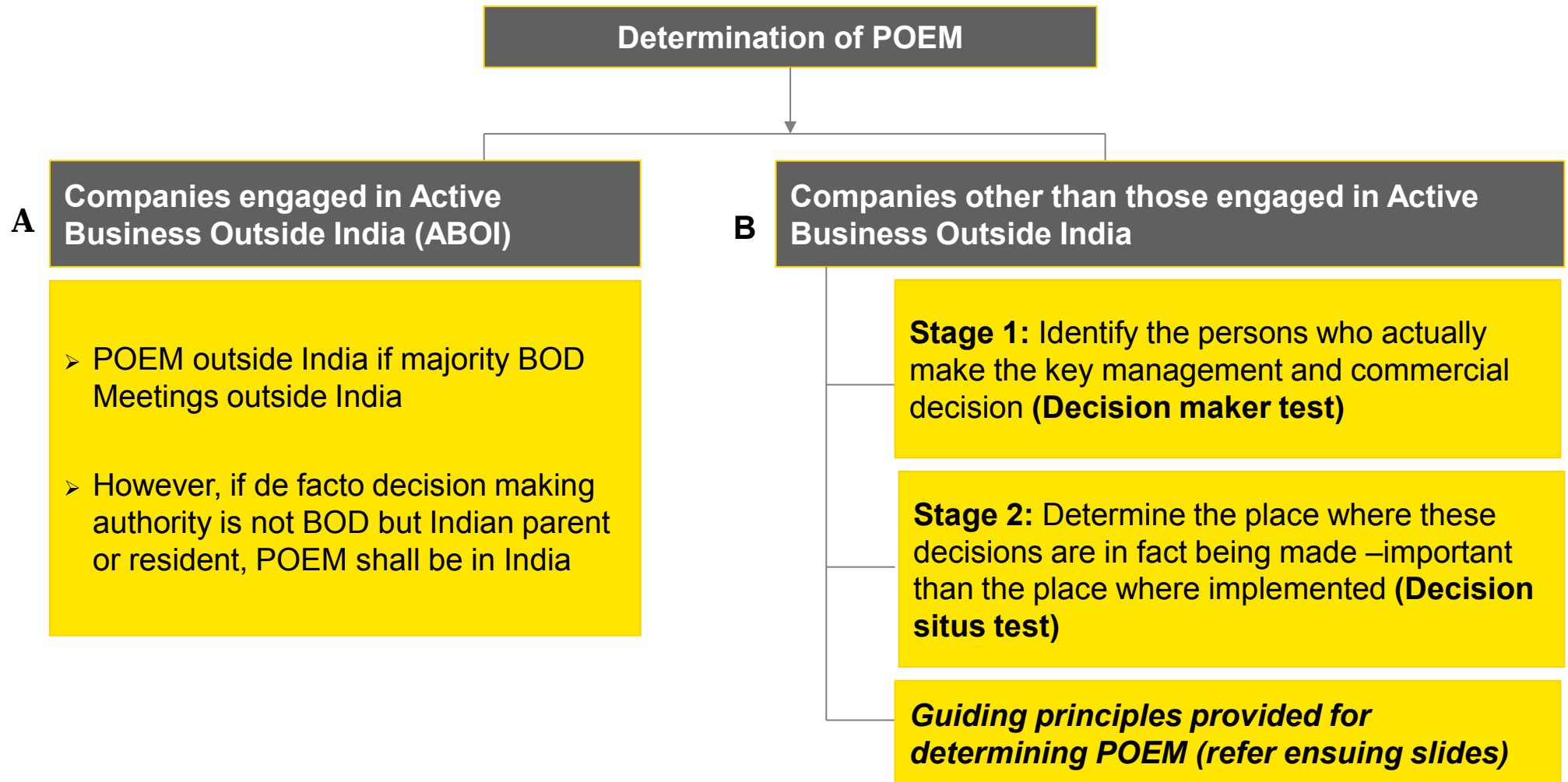
- ▶ Determination of POEM will depend on facts and circumstances of the case
- ▶ POEM is a concept of substance over form
- ▶ Entity may have more than one place of management (POM) but only one POEM
- ▶ De-facto conduct relevant rather than de-jure compliance
- ▶ Exercise necessary for each company every year
- ▶ Snapshot approach should be avoided

Focus is on evaluation of POEM within or outside India

Guidelines define two approaches



Determination of POEM as per Guidelines



POEM Guidelines: Active Business Outside India (ABOI test)



ABOI Test: Green Channel

A company is said to be engaged in Active Business Outside India if it fulfils the cumulative conditions of:

Income Test

Active income is at least 50% of total income



More than or equal to 50% assets outside India;



More than or equal to 50% employees are not resident of India or not situated in India



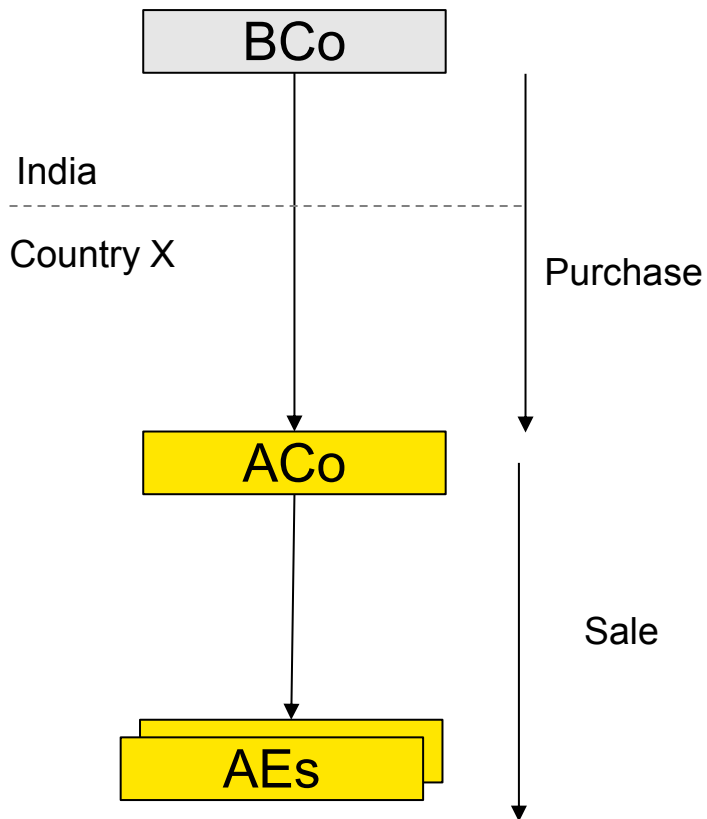
the payroll expenses on such employees **more than or equal to 50%** of total payroll expenditure

In computing each parameter, the average data of previous year and two years prior to that shall be taken into account.

Elements of the ABOI Test

Concept	Clarifications in the Guidelines	
Income	<ul style="list-style-type: none"> As computed for tax purpose as per laws of the COI; or Where the laws of COI do not require such a computation, as per books of account Income needs to be computed but is kept out of computation of total income as per domestic tax laws, determination to be based on books of accounts. (e.g.: exempt income) 	
Passive income: exhaustive list		Active income: illustrations
<ul style="list-style-type: none"> Royalty; Dividend' 		<ul style="list-style-type: none"> Manufacturing or processing activities Income from services
<ul style="list-style-type: none"> Capital gains; Interest (except banking company etc); Rental income Income where sale and purchase with AE 		<ul style="list-style-type: none"> Management fees from group companies E-commerce activities Trading where either the customers/supplier is non AE
Definitions from ITA?		
Page 24	Concept of Place of Effective Management under ITA	July 2017

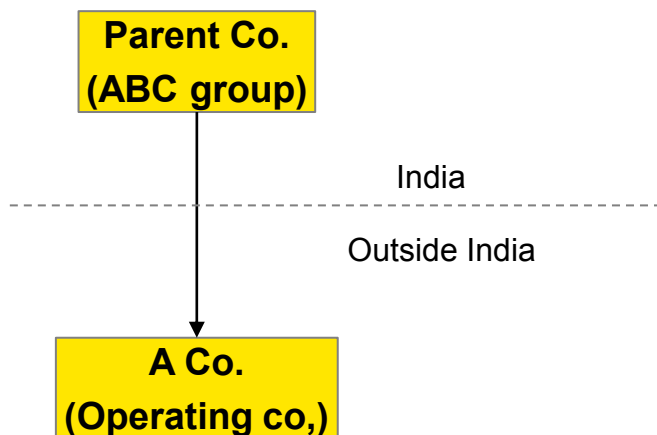
Example 1: Operating income from AE transactions: ABOI Test



- ▶ A Co. is sourcing entity for an Indian MNC incorporated in Country X;
- ▶ ACo. purchases from BCo. and distributes to other companies of the group
- ▶ Assets of Aco. include warehouse and stock in trade which is located in Country X;
- ▶ All employees are situated in Country X (non-residents of India)
- ▶ Income of ACo. consists of income from transactions where both purchases and sales involve AEs at ALP
 - ▶ 100% of income (although operating) is passive income

A Co. fails ABOI Test. POEM of ACo to be evaluated based on situs of C&M

Example 2: Operation of averaging rule for employees

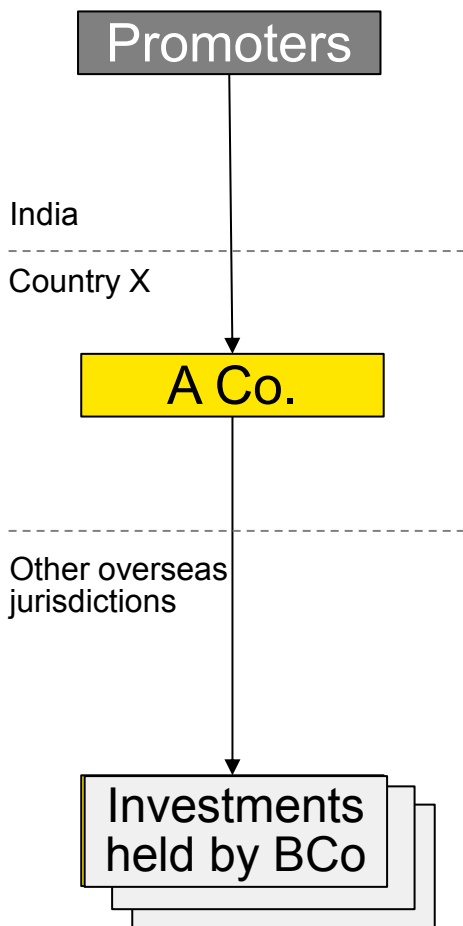


- ▶ A Co. is the overseas subsidiary of ABC group held by Indian parent;
- ▶ For functions such as payroll, billing, etc. of ACo. has employee base in India
- ▶ ACo. earns active income during the relevant three years; All assets are located outside India
- ▶ The employee¹ distribution is as under:

Year	Employees outside India	Total no. of employees	% outside India
	Average of opening + closing	Average of opening + closing	
1	400	600	67%
2	350	800	44%
3	325	725	45%
Average of Year 1- 3			52%

¹ Employee to include persons, who, though not employed directly by the company, perform tasks similar to those performed by the employee.

Example 3: Impact of capital gains on active income test – an area of obscure interpretation



- ▶ ACo is operating cum holding entity for an Indian MNC incorporated in Country X;
- ▶ Assets and all employees of ACo are located in Country X
- ▶ In FY 2017-18, ACo divested 80% of its investments and earned huge capital gains
- ▶ Yearly break up of income of ACo is as under:

Year (FY)	Passive income	Active income	Total income (c) = (a)+ (b)	% passive income (???)
2015-16	-	100	100	0
2016-17	-	100	100	0
2017-18	5000	100	5100	98
Average for FY 2015-16 to 2017-18)				33
2018-19	-	100	100	0
Average for FY 2016-17 to 2018-19)				33

Shareholders' influence on company



POEM and significance of shareholders intervention

Extent of shareholders' influence: Observations from SC Ruling in Vodafone case

SC ruling in Vodafone's case¹

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

¹ (2012)(341 ITR 1)

Decision making on matters reserved for shareholders' consent under statute

- ▶ Decisions affecting existence of company or rights' of shareholders
 - ▶ Sale of all/ substantially all company's assets
 - ▶ Dissolution
 - ▶ Liquidation
 - ▶ Deregistration of company
- ▶ Shareholder's involvement tantamount to effective management if:
 - ▶ Shareholders' take excess decision making powers through formal arrangement (e.g.: shareholder agreement, etc.) or actual conduct
 - ▶ Shareholders' limit authority of board and SM thereby remove company's real authority

Whether shareholder guidance transforms into usurpation of powers is fact based exercise to be determined on case-to-case basis

Adherence to ‘Group global policy’: Extracts from Guidelines

- ▶ Group global policy do not relate to ‘key management or commercial decisions’. For e.g., it may deal with (illustrative list)
 - ▶ Payroll,
 - ▶ Accounting;
 - ▶ Human Resource;
 - ▶ IT infrastructure and network platform;
 - ▶ Supply chain;
 - ▶ Routine banking operational procedures
- ▶ Provided group global policy not specific to any entity or group entities
- ▶ Other areas not specifically mentioned in the Guidelines:
 - ▶ General group-wide policies relating to anti-bribery
 - ▶ Whistle blower mechanism within the group
 - ▶ Countries/regions to cater to (or) products/activities which a group may not pursue
 - ▶ Permissible leveraging for various entities of the Group

An Indian listed parent: Need for an oversight/ MIS

- ▶ Board of parent has severe accountability issue to shareholders
- ▶ Responsibility of protecting and enhancing shareholder value
- ▶ Protecting and enhancing organisational reputation and brand image
- ▶ Assurance of ethical conduct to bankers, SEBI, FI, rating agencies, private equity etc.
- ▶ Ensuring consistent adherence to group policy and vision documents
- ▶ Global banking and guarantee arrangements; need for budget allocation
- ▶ Preparedness to assume devolvement of liabilities of WOS on moral grounds
- ▶ Robust adherence to regulatory environment in each country
- ▶ Prevention of erratic incentive and remuneration policy of senior personnel

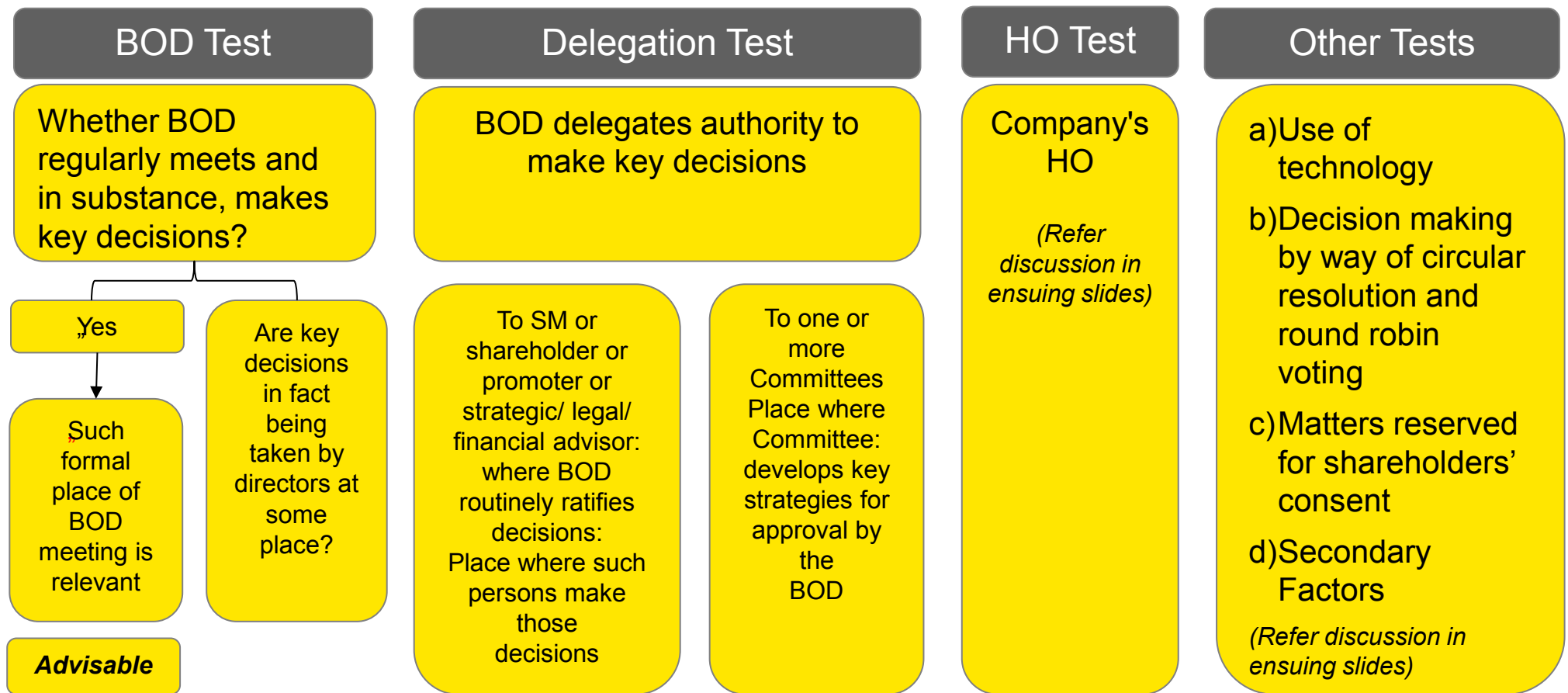
POEM Guidelines

Determination for non-ABOI companies

Failing ABOI Test is not the end of the story!

Snapshot of factors of determination of POEM (non ABOI)

Determination of POEM (Para 8 of Guidelines)
No clear specification of hierarchy of various tests



Location of decision making by Board of Directors

- ▶ Place where Board regularly meets and takes decisions is the POEM
 - ▶ If BOD “retains” and “exercises” its authority to govern the company and does, in substance make decisions for the whole entity
 - ▶ Intelligent consideration of decisions; rather than ratification
 - ▶ One or some directors reside in India is not conclusive
- ▶ Place of meetings persuasive – but, not necessarily conclusive
- ▶ Adverse inference: Board Meeting is held in a location distinct from situs of directors or from HO

Location of Company's Head Office (HO test)

Head Office

Place where Senior Management (SM) is based can influence the location of HO. HO is where SM is predominantly or primarily located. **There is a prima facie relevance / presumption that key management decisions are often made at HO.**

Single Location

Decentralised: Multiple Locations

SM participates via Telephone/ VC

Extremely Decentralised HO

OR

OR

► Place where SM¹ + DSS¹ are located

► Such place is held out to public as HQ / principal place of business

Where SM are primarily/ predominantly based

Normally return to following travel to other locations

Meet when formulating or deciding key strategies and policies for the company as a whole

Where the highest level of management + DSS are located

► Not possible to determine with reasonable certainty

► HO not relevant for POEM determination

¹Need not be employees
DSS= Direct support staff

Observations on Senior Management (SM)

- ▶ SM are persons generally responsible for developing and formulating key strategies / policies for the company (as a whole) **and** for ensuring execution and implementation on a regular and on an ongoing basis
 - ▶ Person is SM if “generally responsible for developing and formulating key strategies and policies and for overseeing their executive and implementation”;
 - ▶ Definition attracted even if not decision maker??
 - ▶ SM may include MD/ CEO; Financial Director/ CFO; COO, heads of various divisions
- ▶ Location of HO would be very important factor as it often represents where key company decisions are made
- ▶ As opposed to SM, day to day routine operational decisions undertaken by junior/ middle management not relevant for POEM determination

Factors of relevance, but not conclusive evidence

- ▶ Foreign company owned by Indian company not conclusive
- ▶ Some directors of foreign company resides in India, not conclusive
- ▶ Existence of PE in India also not conclusive
- ▶ Local management of FCo. in India for routine (non strategic) matters is by itself not conclusive evidence
- ▶ Support functions (**of P&A nature**) or implementations of decisions in India will not be conclusive evidence

Transitional provisions (s. 115JH): Draft Notification

Draft Notification specifying manner for ITA provisions to apply to first time POEM resident Fco. (illustrative list):

- ▶ WDV of depreciable asset:
 - ▶ WDV as per tax records/ books maintained as per foreign jurisdiction as on 1 April of the FY for which Fco. is POEM resident
- ▶ Brought forward loss (b/f loss) and unabsorbed depreciation (UAD) :
 - ▶ Loss and UAD as per tax records/ books to be determined year- wise on the first day of the FY for which Fco. is a POEM resident;
 - ▶ Such determined loss and UAD deemed to be brought forward as on 1 April of the FY for which Fco. is a POEM resident;
- ▶ POEM resident Fco. entitled to relief/ deduction of taxes paid outside India as per s. 90 of ITL;
- ▶ All provisions of ITA as applicable to foreign company continue to apply (e.g.: Tax rate of 40%)
 - ▶ Provisions as applicable to 'non-resident' shall not apply and provisions specifically applicable to 'resident' shall apply

Transitional provisions (s. 115JH): Significant recommendations

- ▶ ROI filed by foreign company pursuant to POEM determination in India to be considered as ROI filed within 139(1) time limit.
- ▶ Compliance obligations: Tax Audit report, TP report, CbCr:
 - ▶ Procedural compliances of filing report may be relaxed;
- ▶ Vicarious liability: TDS/ TCS liability: FCo. may not be held to be assessee in default
- ▶ Computation of business income: ICDS may not be made applicable during transition period;
- ▶ Reorganisation which is tax neutral in the foreign company jurisdiction will equally be accepted to be tax neutral in India.
- ▶ To supplement the draft notification with suitable illustrations for comprehensive interpretation

Way forward

- ▶ Wide powers and authority in shareholders or MD or ED tilt balance; majority directors outside India- holding of meetings outside India
- ▶ Meetings supported by agenda papers, discussion, decision at Board meetings
- ▶ Delegation of authority in favour of personnel outside India – HO involvement by exception
- ▶ Advisory / recommendations from parent (v) directions
- ▶ Charter documents, senior personnel appointment letters to bear out independence
- ▶ Beware of social media interactions of senior employees in India – their profile and designation; LinkedIn, social sites, visiting cards, website, travel documents, etc.
 - ▶ Social media is a bigger source of information than EOI !!
- ▶ Maintain strike rate of discipline !

Thank You!

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