India

India and Its Tryst with Subjective Rules: An Analysis of the Recent Place of Effective Management Guidance

Sriram Govind

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This article examines India’s recent introduction of the subjective place of effective management test to determine Indian tax residence. The author provides an overview of international corporate tax residence rules, and Indian corporate tax residence rules before and after the adoption of the place of effective management test. The article addresses the Indian Central Board of Direct Taxes’ January 2017 Circular, which is intended to elucidate application of the place of effective management test in India, and critiques its effectiveness in providing clarity and certainty to taxpayers. [Ed. Note that this article was finalized for publication before the OECD released the reservation and notification statement for India to the Multilateral Convention (2016) on 7 June 2017.]

1. Introduction

Until 2015, a company was considered to be a tax resident in India only if its control and management were wholly based in India. This left room for companies active in India to move part of their management abroad, to prevent India from taxing their worldwide income. The Finance Act 2015, enacted as part of the 2015 Budget, modified this rule by adopting a subjective “place of effective management” (POEM) test, whereby any company would be considered an Indian resident if its POEM is in India during a relevant tax year.

However, it became clear later that the provision needed implementing rules to give it the necessary teeth, and its implementation was deferred until 1 April 2017. While draft guidance was released for consultation in December 2015, after a year of discussions, the final POEM guidance (POEM Guidance) was released on 24 January 2017,[1] in an attempt to ensure that the rules were understood before the provision came into force.

While the international tax world is gearing up for major changes to the globally accepted anti-avoidance framework, based on the Base Erosion and Profit Shifting (BEPS) Project, the POEM Guidance was expected to give some clarity about the application of the POEM test under Indian law.

This article aims to analyse the POEM Guidance in order to determine whether it succeeds in giving clarity and predictability to Indian taxpayers and businesses having tax exposure in India. Section 2. analyses corporate tax residence rules from an international perspective, along with country practice, before looking at the Indian corporate tax residence rules, prior to and following the introduction of the POEM rule. Section 3. details the rules contained in the POEM Guidance and section 4. analyses how effective they are in providing certainty and clarity. Finally, section 5. contains some concluding remarks.

2. Corporate Tax Residence Rules: An Overview

2.1. International tax rules and state practice

2.1.1. Domestic rules

Under corporate law, the residence of companies has always been based on either the “incorporation theory” or the “real seat theory”. Conflicts involving the legal status of a company belonging to a state that follows the former approach and its treatment in a state that follows the latter approach.

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follows the latter approach has been much discussed in legal literature.[2] Although similar, “residence” for corporate taxation purposes is determined differently, since here the jurisdiction of the tax authorities and not the “proper law” of the company is to be determined.[3]

Corporate tax residence is determined both to understand the company’s tax liability under domestic law and to understand whether the company may claim benefits under a double taxation convention entered into by a state.[4] For corporate taxation purposes, residence is determined on the basis of connecting factors, such as place of incorporation, POEM or nationality of those having voting control of the company.[5]

In general, most countries (and especially civil law countries) follow, inter alia, the POEM approach to determine corporate residence.[6] However, most of these countries follow a case-by-case approach, depending on facts and circumstances, and do not provide sufficient objective guidance on how the residence tests are to be applied. Different perspectives are seen from court decisions in these countries on the substantive, personal or territorial scope of the POEM.[7]

Common law countries also use similar criteria, especially the “central management and control” criterion developed in the United Kingdom (UK). It is important to note that case law has largely developed the notion of corporate residence for tax purposes in common law, which indicates that the finding is still a fact based, subjective exercise.[8]

Although most other countries do not provide statutory guidance on the determination of POEM, case law in these countries suggests that the place where effective strategic decisions are taken would generally constitute the POEM. French case law suggests that the place where the strategic centre of the company (which usually establishes the guidelines for the conduct of its business) is located and where the heads of direction, management and control of the entity are, in fact, mainly located would constitute the POEM.[9] Further, in the Netherlands, a general assumption was upheld that the effective management of an entity is delegated to the board of directors, and that the POEM would be the place where the board of directors performs its tasks. However, if it is likely that another person exercises (or other persons exercise) effective management, the location of such person (or persons) may be considered the POEM.[10] Therefore, Dutch precedents generally point towards an approach following the effective or material exercise of the “strategic management” of the company.[11]

In Spain, various cases have followed a formal approach, which looks at the location of board meetings, books of account or the residence of the directors,[12] and a broader approach, which looks at the place where the company’s global strategy is defined or the place of resource allocation to the management of the company.[13]

Further, German case law provides that the place where management decisions are taken with a certain degree of regularity would constitute the POEM, and this would be where people representing the company take day-to-day management decisions.[14] However, if this authority is delegated, then the person exercising such authority would determine the POEM.[15] Moreover, in Italy, following both

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3. See Behrens, supra n. 2.


5. See P. Behrens, supra n. 2. Although these concepts are similar to the “proper law” theories mentioned above, they cannot be applied identically since they are derived from different perspectives.

6. As noted in L. De Broe, Corporate Tax Residence in Civil Law Jurisdictions, in Maisto, supra n. 2, chap. 4, civil law countries, such as Austria, Belgium, Italy, Spain, Germany, Switzerland and the Netherlands, all directly or indirectly provide for a POEM criterion to determine corporate tax residence.

7. Consider, for example, the substantive scope. While France and the Netherlands refer to “strategic management” and the most critical areas of control of a company, Switzerland takes the opposite view, by referring to day-to-day management of the company. The situations in Spain (referring to management and control of “all activities”), Belgium (referring to principal establishment, seat of management or administration) and Germany (referring to the “center of chief business administration”) are unclear, although they do tend towards “strategic management”. However, the Austrian and Italian positions are even vaguer, where it is difficult to determine whether they consider strategic or day to day management; see De Broe, supra n. 6.

8. The evolution of the case law, from De Beers Consolidated Mines Ltd v. Howe (1906) AC 455, which laid down the notion that a UK incorporated company having a foreign board of directors could be non-resident to Swedish Central Railway Company v. Thompson 9 TC 342, where a possible divide in control and management, pointing towards a factual exercise, was laid down (although it was misinterpreted to include an incorporation and a place of business test) to Egyptian Delta Land and Investment Co Ltd v. Todt [1932] 1 KB 152 (High Court and CA); [1929] 1 AC 1 (HL); 14 TC 119, where it was held that incorporation in the UK was not a conclusive factor for residence to Union Corporation Ltd v. IRC [1952] 1 All ER 646; [1953] 1 AC 482; (1953) 34 TC 207, where the place of lesser control and management was also held to constitute residence, is detailed in J.F. Avery Jones, Corporate Residence in Common Law: The Origins and Current Issues, in Maisto, supra n. 2, chap. 5. In modern times, this test has evolved in Australia to take into account situations where the board abrogates its decision making power in favour of an outsider: see Bywater Investments & Ors v. Commissioner of Taxation, Hua Wang Bank Berhad v. Commissioner of Taxation, infra n. 46.


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statutory and case law the place of strategic management of the company would determine the POEM, although practice in this area tends to refer to daily management as well, thus creating confusion.\[16\]

In sum, although a large number of decisions from both civil law and common law jurisdictions seem to favour the strategic management approach, there is no consensus on this and most states prefer to use a case-by-case approach to determine the POEM.

\[1.2.2. \text{Treaty rules}\]

The POEM rule is also relevant in the context of income tax treaties, since it has been used as the “tie-breaker” for dual resident companies under article 4(3) in many tax treaties.\[11\] While the original League of Nations Mexico model income tax treaty of 1943 used the incorporation principle as the tie-breaker test, the London model of 1946 replaced that test with a “real centre of management” test. Although a “management and control” test as applied in the United Kingdom was used in the first OEEC working party report,\[19\] this was later changed to the POEM test in the working party’s final report,\[19\] so as to harmonize the language with the shipping article.\[20\]

This expression was used in the 1963 OECD Draft Convention and later in the 1977 OECD Model Convention, without much further guidance in the OECD Commentary on Article 4. In the 2000 update to the OECD Model, the Commentary on Article 4 was also updated, stating that the POEM is: \[21\]

the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined ... \[22\]

Although until 2000, the Commentary seemed to refer to strategic management criteria regarding the substantive scope of POEM,\[23\] in the 2008 update the OECD modified the above paragraph in the Commentary to remove the second sentence. Therefore, only the first sentence (i.e. “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made”) has been retained, making the Commentary increasingly vague.\[24\]

The United Nations (UN) Model replicates the OECD Model provision, but the Commentary to the UN Model provides some additional guidance. In respect of dual residence and related tax avoidance, the UN Commentary notes that the mere fact that board meetings occur in a state does not make that State the location of the POEM.\[25\] Further, the UN Commentary states that: \[26\]

... when establishing the “place of effective management”, circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept ...

\[16\] See Pötgens, et al., supra n. 9.

\[17\] Tax treaties ordinarily provide entitlement to treaty benefits if a company is resident of one or both of the contracting states involved. Since residence for this purpose is generally determined by a country’s domestic tax laws, it is common for a company to be considered a resident of both of the contracting states.


\[21\] Commentary on Article 4, para. 24 (2000).

\[22\] This language was still found to be unsatisfactory by many. In a letter to the OECD, Prof. Luc de Broe suggested the following wording be added to the Commentary for clarity: “... [w]here a board of directors formally finalizes and/or routinely approves key management, commercial and strategic decisions necessary for the conduct of the entity’s business in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State. In determining the place where a decision is in substance made, one should consider the place where advice on recommendations or options relating to the decision were considered and where the decision was ultimately taken.” See L. de Broe, Comments on the 2008 Update to the Model Tax Convention – Place of Effective Management (25 Feb. 2008), available at https://www.oecd.orgctp/treaties/40760215.pdf.

\[23\] In fact, in a 2003 discussion draft, the OECD’s Technical Advisory Group proposed additions to the Commentary to specifically clarify that the POEM should relate to strategic management decisions: see OECD Technical Advisory Group, Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention (OECV, 27 May 2003), available at http://www.oecd.org/tax/treaties/2966428.pdf.

\[24\] The OECD also allows countries the option to move away from this test and to use the case-by-case mutual agreement procedure in the Commentary. This option was still found to be unsatisfactory by many. In a letter to the OECD, Prof. Luc de Broe suggested the following wording be added to the Commentary for clarity: “... [w]here a board of directors formally finalizes and/or routinely approves key management, commercial and strategic decisions necessary for the conduct of the entity’s business in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State. In determining the place where a decision is in substance made, one should consider the place where advice on recommendations or options relating to the decision were considered and where the decision was ultimately taken.” See L. de Broe, Comments on the 2008 Update to the Model Tax Convention – Place of Effective Management (25 Feb. 2008), available at https://www.oecd.orgctp/treaties/40760215.pdf.

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\[26\] The OECD also allows countries the option to move away from this test and to use the case-by-case mutual agreement procedure in the Commentary. This option has now been translated into hard law under the OECD’s Multilateral Instrument, see infra n. 28. The only other reference to the meaning of the expression in OECD documentation is contained in the Commentary to the detailed limitation on benefits clause in the Final Report on BEPS Action 6 where the expression “primary place of management and control” is described in relation to that clause. The proposed Commentary states: “75. The term “primary place of management and control” is relevant for the purposes of subparagraph c) of paragraph 2. This term must be distinguished from the concept of “place of effective management”, which was used, before [date of the next update], in paragraph 3 of Article 4 and in various provisions, including Article 8, applicable to the operation of ships and aircraft. The concept of “place of effective management” was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company’s business. The concept of the primary place of management and control, by contrast, refers to the place where the day-to-day responsibility for the management of the company (and its subsidiaries) is exercised ... : see Final Report on BEPS Action 6, section A, p. 50.

\[25\] UN Commentary on Article 1 (2011), para. 45.

\[26\] UN Commentary on Article 4, para. 10.
However, these are only guiding principles: even in the UN Model, determination of the POEM remains subjective. Accordingly, commentators and authorities around the world have held the test to be inconclusive, resulting in different tests being adopted in different countries to resolve dual residence.[27]

In light of these issues and the possible tax planning opportunities in case of mismatch of rules, the final report of Action Plan 6 of the BEPS Project has suggested moving away from the POEM test for dual resident entities towards a solution by mutual agreement. On this basis, the text of the Multilateral Instrument (MLI)[28] provides the option, in article 4(1), for countries to adopt this change in their bilateral tax treaties.[29]

2.2. Corporate tax residence rules in India

Originally, the Indian Income Tax Act 1922 sought to define residents and non-residents separately, while establishing a scheme of worldwide taxation for residents and source-based taxation for non-residents.[30] Section 4A of the Income Tax Act 1922 considered a company to be an Indian resident in two situations:

1. if it was an Indian company, i.e. incorporated under Indian law; or
2. if the control and management of the company during the year was wholly situated in India.[31]

As the Income Tax Act 1922 was replaced by the Income Tax Act 1961, the same provision was inherited in the new section 6(3) of the 1961 Act, and this provision was retained until 2015.

The meaning of “control and management” and “wholly situated in India” has been considered by Indian courts on several occasions. In VVRNM Subbayya Chettiari (HUF) v. CIT,[32] the Supreme Court referred to Swedish Central Railways Company Limited[33] and held that the expression “control and management” signified the control and directing power of a company, in the sense of the “head” and “brain” of the company.

Further, in Narottam and Pereira Ltd. v. CIT,[34] the Bombay High Court held that the controlling and directive power must be established in India with a degree of permanence, and that the presence of directors in India is sufficient to establish residence even though controlling managers operated abroad.

In Radha Rani Holding (P) Ltd v. Additional Director of Income Tax,[35] the Delhi bench of the Income Tax Appellate Tribunal (ITAT) held that, even if one of two directors of a company is present in India, the test of control and management being “wholly situated” in India would not be satisfied, since board meetings were conducted outside India.

Based on this line of case law, it was accepted that a company could potentially shift part of its control and management outside India to avoid being considered a tax resident and subject to taxation in India on its worldwide income. This led to several tax avoidance opportunities, since Indian companies started hiring foreign directors and conducting board meetings in tax-neutral jurisdictions so as to reduce their tax liability in India.

Consequently, the test contained in section 6(3) of the Income Tax Act 1961 was proposed to be replaced by the POEM test in the Direct Taxes Code Bill 2010 and subsequently in its 2013 version. However, neither of these bills translated into law (as they lapsed). Finally, the Finance Act 2015, passed as part of the 2015 Budget, established the replacement test.

Under the new wording of section 6(3), a company is considered to be a tax resident of India if it is an Indian incorporated company or if its “place of effective management”, in that year, is in India.[36] Further, the term “place of effective management” was defined as:

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

According to the Memorandum explaining the provisions of the Finance Bill 2015, the rationale behind this measure is to remove the flexibility in the previous rules, to move towards the “internationally recognized” concept of POEM, as recognized by the OECD, and to

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27. See, for example, S. van Weeghel, Article 4(3) of the OECD Model Convention: an Inconvenient Truth, in Maisto, supra n. 2, p. 304; J.F. Avery Jones, Place of Effective Management as a Residence Tie-Breaker, 59 Bull. Intl. Taxn. 1 (Jan. 2005), pp. 20-21; Journals IBFD; and S. Nenadic, Tie-Breaker for Dual Resident Companies, in M. Seiler & D. Blum (eds.), Preventing Treaty Abuse (Linde 2016), pp. 134-137. For an example of practice, consider case BNB 2007/36 of the Dutch HoGE Raad, where a change in the POEM as part of tax planning was upheld; however, case BNB 2013/54 states that such a shift should be “genuine”, leading to a narrow test: see D.S. Smit, Dutch Supreme Court 30 November 2012, BNB 2013/54: Determination of the place of effective management of a non-active company, in M. Lang, et al. (eds.), Tax Treaty Case Law around the Globe 2013 (2013), Online Books IBFD.


29. This option was already provided to countries in para. 24.1 of the OECD Model Commentary on Article 4 (2014).


31. As noted above, the expression “management and control” is used in UK law to determine corporate tax residence, which, based on case law, has led to notable confusion.


33. Supra n. 7.

34. (1953) 23 CompCas 185 (Bom).

35. [2007] 110 TIT 920.

36. The initial text allowed this test to be triggered if the conditions were met “at any time” during the year. That phrase was later replaced in the final version of the Finance Act 2015.
align with India’s tax treaties, since the expression “place of effective management” and its definition have been imported from the OECD Model and Commentary.

The new provision came into effect on 1 April 2015, and remained in effect until 1 April 2016. However, owing to representations made by interested parties, and the fact that several areas of the Income Tax Act 1961 could not be applied to companies that were non-resident without detailed guidance, the date of the provision coming into force was extended to 1 April 2017. Subsequently, draft guidance for the application of POEM was issued in December 2015, leading to the release of the final POEM Guidance in January 2017.

As noted above, although POEM and similar criteria are adopted in several states, there is no clarity as to their scope, which undermines certainty and predictability for taxpayers. In light of this, it was much expected that the POEM Guidance would provide detailed, objective guidelines on the application of the provision.

3. POEM Guidance: An Analysis

The POEM Guidance was released as a circular by the Central Board of Direct Taxes (CBDT). It is settled law in India that such circulars, although binding on the tax department, are not binding on taxpayers.[37] However, since the tax department is bound to apply it, a taxpayer may only contest its application at an appellate level, which makes it necessary to analyse the contents of the POEM Guidance from a legal perspective.

At first glance, the POEM Guidance appears to be almost identical to the draft guidelines released in 2015, except for a few procedural modifications. Although the government may have received detailed feedback on the draft guidelines over the course of 2016, it is surprising that there are no substantive changes to them. However, since the POEM Guidance has now been finalized, the provisions deserve a closer look to identify possible areas of concern.

3.1. Active business test

The POEM Guidance clarifies that the determination of a POEM will be a year-to-year exercise, as is the case with tax residence, and would depend on whether a company engages in active business outside India. For ease of reference, this is referred to as the “active business test” in this article.

The active business test would be satisfied (i.e. a company is deemed to be engaged in active business outside India) if four separate conditions are all met on an average basis across the three previous accounting years (or period since incorporation if the company has existed for less than three years), in accordance with the incorporation country’s laws:

1. **Income rule:** Income by way of dividends, royalties, capital gains, interest (excluding interest earned by regulated banking and public finance companies), rental income or business income from transactions involving both the sale and purchase of goods to associated enterprises is not more than 50% of the company’s total income, as computed under incorporation country’s laws or, in absence of such laws, the company’s books; and

2. **Asset rule:** Less than 50% of the value of the company’s total assets (average value for tax purposes for depreciable assets and book value for other assets) are situated in India; and

3. **Employee rule:** Less than 50% of total employees or similar personnel (average number between the beginning and end of year employee count) are situated or resident in India; and

4. **Payroll rule:** Less than 50% of total payroll expenses (including salaries, wages, bonuses, social security payments, etc.) are spent on employees situated or resident in India, mentioned in (3) above.

If the active business test is satisfied, the POEM is presumed to be outside India if the majority of the meetings of the board of directors are held outside India. However, even in that case, the POEM would be considered to be in India if the directors are inactive and their powers are exercised by Indian residents. The directors would not be considered inactive per se if they only follow general and objective principles of global policy of the group laid down by the parent entity, which may be in the field of payroll functions, accounting, human resources, IT infrastructure and network platforms, supply chain functions or routine banking operational procedures, which are not specific to any entity or group of entities.

In this situation, the rules provide for a presumption in favour of the taxpayer, which can only be overturned if it is clear that Indian persons take management decisions on behalf of the board of directors. This formulation, comprising a presumption based on an objective test and the subjective authority to overturn it based on clearly defined criteria, is a well thought-out solution for determining tax residence. However, there are several concerns, which may be raised regarding the active business test itself.

First, a broad three-year test, applied on an average basis, would lead any company that is not situated in India and having a lull in active business outside India in the past three years or first few years of incorporation to not satisfy the criteria, even if it presently undertakes active business.

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Second, the terms “dividends”, “royalties”, “capital gains”, “interest”, “rental income” and “business income” in the income rule are left undefined. It is therefore unclear whether characterization by the tax department at the first instance would be sufficient for initiation of proceedings. This is particularly problematic in light of the Indian tax department’s attempts in the recent past to characterize transactions falling outside the scope of the permanent establishment (PE) threshold as “royalties”, which have, in some cases, even been successful when challenged in the courts.[38] Although an exception has been made for active interest,[39] no exception has been made for active royalties.[40] Since modern business models may lead to royalties being more along the lines of active income in several cases, always treating royalties as passive income may lead to tax residence consequences in India in unwarranted situations.

Third, transactions involving the sale and purchase of goods with associated enterprises are broadly considered to produce passive income in the POEM Guidance. However, any such transaction involving an Indian associated enterprise may lead to active income in India (valued at arm’s length under Indian transfer pricing norms) and be taxable in India. Further, even if two associated enterprises are located outside India, if one is considered a resident of India under the POEM test, Indian transfer pricing rules would apply.[41] Moreover, it is unclear why only transactions involving goods are covered (the term “goods” being undefined), and services are not included.

Fourth, it is not clear whether the presence of employees for the purposes of the employee test would be determined by way of general presence in India (allowing inclusion of even a one-day stay), without an express threshold, and whether the test would also include employees who arrive in India for supervisory or stewardship activities.[42]

Since an attempt at objectively narrowing the scope of the POEM criteria through an active business test is a novel approach, it is important that the wording used is clear and precise. If the POEM Guidance is retained in its present form, unless judicially clarified there would be no conclusive answer to the above questions; thus, steering us towards increased litigation.

3.2. Guidelines for the determination of passive income

If the active business test is not satisfied (i.e. if a company does not meet the conditions required to be considered as engaged in active business outside India), a subjective rule is laid down first to determine the persons responsible for the key management and commercial decisions relevant to the conduct of the company’s business as a whole and then to determine where these decisions are taken in substance, rather than where they are implemented. No guidance is provided on the exact scope of key management and commercial decisions beyond what is provided in the law, thereby ensuring that a large part of the determination of POEM remains purely subjective. The expressions “key management and commercial decisions”, “conduct of business of an entity as a whole” and “in substance” are left undefined and not even an inclusive definition of these terms has been provided.[43] However, some broad principles, which are neither conclusive nor binding, are also prescribed to aid this decision. These principles are discussed below.

3.2.1. Location of board meetings

The location of meetings of the board of directors may be considered the POEM if the board effectively governs the company and, in substance, takes the effective management decisions. However, merely holding formal board meetings would not be conclusive determination of a POEM. If key decisions are taken in a place separated from the head office or the place of predominant activity, the POEM may correspond to that separate place.

Further, de jure or de facto delegation of powers by the board to others, such as an executive committee, would result in determination of a POEM at the location of the person(s) actually exercising such powers.

38. See Verizon Communications Singapore Pte Ltd. v. ITO [2014] 361 ITR 575 (Mad), where the Madras High Court held that payments made for international connectivity services, such as bandwidth services, constitute royalties; CIT v. Samsung Electronics Co. Ltd (2011) 203 Taxman 477, where the Karnataka High Court held that payments made for shrink-wrap, off-the-shelf software are in the nature of royalties (cited with approval in CIT v. Synopsys International Old Ltd [2012] 28 taxmann.com 162); Commissioner of Income Tax, International Taxation v. Rational Software Corp. (India) Ltd [2012] 22 taxmann.com 9 (Karnataka); and Commissioner of Income Tax, International Taxation v. Sonata Information Technology Ltd [2012] 21 taxmann.com 312 (Karnataka). This argument was not upheld by the Delhi High Court in DIT v. Nokia Networks OY [2012] 233 CTR 417 (Delhi) and DIT v. Ericsson AB (2012) 66 DTR 1, nor in the context of payments made for the right to access an electronic database in CIT v. Wipro Ltd [2011] 203 TAXMAN 621 (Kar), and in the context of cloud model services, such as advertisement services through search engines and hosting services, in ITO v. People Interactive (I) Pvt. Ltd., TS-129-TAT-2012, ITO v. Right Florists Ltd, I.T.A. No: 1336/ Kol/ 2011, Pinstorm Technologies Pvt Ltd v. ITO [2012] 54 SOT 78 (Mum) and Yahoo India Pvt Ltd v. DCIT [2011] 140 TTJ 195 (Mum).

39. The income rule, discussed above, contains an exception for interest earned by regulated banks and finance companies, which may be considered income earned through their business activities. Therefore, such interest is not considered as “passive” for the purpose of this rule.

40. Royalties could also be considered “active income” in cases where the primary business activity of a company is licensing. Such royalties could therefore be outside the purview of “passive income”.


42. The service PE provision contained in several Indian treaties is imported from the UN Model, which contains similar requirements for the presence of employees and personnel in India for the creation of a PE. This has led to widespread judicial decisions, even though most of the provisions contain a time threshold for presence of employees. See generally cases such as DIT (IT) v. Morgan Stanley & Co. (2007) 292 ITR 416 (SC), Centrica India Offshore (P) Ltd. v. CIT [2014] 364 ITR 336 (Delhi) and DIT v. E-Funds IT Solutions [2014] 364 ITR 256 (Del) for when a service PE can be triggered, especially in light of the India-United States tax treaty, which does not contain a time threshold for a service PE in the case of associated enterprises. Further, the courts have excluded stewardship services from the scope of a service PE.

43. While it is understood that delegated legislation is generally not the place for definition provisions and that definitions of these terms should be added in the law, the approach used in the POEM Guidance makes it clear that the government intends to allow subjective discretion and not to provide objective definitions of the terms used in this provision.
3.2.2. Location of head office

The head office of a company is defined as 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. That place need not necessarily be the same as the place where the majority of the employees work or where the board typically meets.

Further, “senior management” is defined as persons 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 ongoing basis. It may include the managing director or chief executive officer, the financial director or chief financial officer, the chief operating officer and the heads of various divisions or departments.

The location of the head office of the company would be relevant for determination of the POEM on the basis that the senior management are predominantly present there to take decisions. In case the senior management operate from several locations, the location of the highest level of management would be relevant for the POEM determination. However, in an entirely decentralized organizational structure, the location of the head office would not be of much relevance for determination of the POEM.

3.2.3. Role of technology

The POEM Guidance acknowledges the fact that technology may be used for POEM decisions, with the decision makers possibly being present in different parts of the world. In such a situation, the location of the person taking the majority of decisions should be identified.

3.2.4. Voting factors

Where circular resolutions or a “round-robin” form of voting is used, the persons exercising the authority should be identified, based on past practices and general conduct, and their location would be relevant to ascertain the POEM.

3.2.5. Shareholder-level decisions

Typically, the place that shareholder-level decisions, which affect the rights of the shareholders and not the conduct of the company itself, are taken would not lead to a POEM. However, if the shareholder decisions undermine the board or senior management, and are effectively management decisions, they may be important for determination of the POEM.

3.2.6. Junior management and operational decisions

The POEM Guidance clarifies that the location of junior management and operational or day-to-day decision making would not be relevant for determination of a POEM. Therefore, the POEM Guidance clearly indicates that it would follow the strategic management approach in international case law.

3.2.7. Residual test

If the above tests do not lead to a clear answer, the place of substantial activity of the company or the place where accounts are maintained can also be considered for determining the POEM.

3.2.8. Situations that are not conclusive of a POEM

For a foreign company, ownership by an Indian entity, existence of an Indian PE, presence of some directors in India, local management in India, or preparatory or auxiliary activities in India would not be conclusive evidence of a POEM in India.

4. Issues To Be Considered

From the analysis above, it is clear that the global standard on determination of a POEM involves subjective tests and, in most cases, little guidance is provided.[44] Courts in the same country have used both the strategic management approach and the day-to-day management approach to decide the substantive scope of a POEM, working strictly on a case-by-case basis. In this context, the POEM Guidance may give some clarity since it follows the strategic management approach consistently, clarifies that the place where decisions are taken (and not implemented) should have more relevance and provides solutions in several specific situations. Further, clarification that an Indian presence in general is not conclusive of a POEM in India would come as a relief for taxpayers, who have been uncertain about the application of the provision.

From a tax policy perspective, it is important that the POEM Guidance states that the mere fact that the directors of a company are not in India would not lead to the finding that the POEM is not situated in India, and that foreign directors acting as “rubber stamps” for decision making would not be acceptable. This clarifies that the Indian law until now (which facilitated avoidance of worldwide taxation in India

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[44] The most prominent country that provides extensive guidance is South Africa. In 2002, the South African Revenue Service (SARS) issued Interpretation Note 6, which pointed towards day-to-day management of the company for determining the POEM. This guidance was not followed in Oceanic Trust Co. Ltd N.O. v. Commissioner for South African Revenue Service (2001) 1 SA 1109 (CC), where the OECD approach was followed instead. Subsequently, the interpretation note was revised (in 2015) to align it with the OECD explanation, with some added guidance on how a substance-over-form approach must be used to determine where the decisions are actually, and in substance, made.
through such arrangements) has effectively been overruled. This is consistent with the anti-avoidance outcomes of the BEPS Project, which have been accepted by India.[49] This is also in line with recent jurisprudence in common law jurisdictions.[46]

However, the POEM Guidance is still largely worded in broad terms, not going beyond “relevance” for determination of a POEM, and allowing the tax department to retain discretion. Except for a few solutions in specific cases, the POEM Guidance does not provide any conclusive, generally applicable answers. Together with the fact that the Indian Revenue authorities are known to adopt an aggressive approach, rules allowing broad subjective discretion may create problems for businesses, which have a tax exposure in India. Retaining an objective presumption prior to subjective discretion as in a case where the active business test is satisfied[47] may have been preferable from the standpoint of legal certainty.

One should also not underestimate the influence of judicial and quasi-judicial authorities in India, in developing the law on subjective tests.[48] Decisions by Indian courts and the ITAT on POEM in India’s income tax treaties should still be applicable to the interpretation of section 6(3) of the Income Tax Act 1961.[49] In In re. P No. 10 of 1996, [50] the Authority for Advance Rulings (AAR) held that the location of the board of directors would still be considered the POEM, even if they received recommendations from India. Further, in In re. X Ltd, [51] and DLJMB Mauritius Investment Co[,] the AAR held that the POEM would be the location of the board of directors of the company, even though there was an allegation of control by the foreign parent. This position was also upheld by the ITAT in Saraswati Holding v. DDIT,[53] in the context of Mauritius-based holding companies.

Even though the POEM Guidance provides guidelines on application of the POEM test in several situations, as noted above it is not binding on a taxpayer. Therefore, the taxpayer is always likely to rely on the cases to claim the same treatment in similar situations, even where the POEM Guidance provides otherwise, since the wording of erstwhile treaties and the OECD Commentary has been transposed directly into Indian law.[54]

Further, in a measure aimed at providing relief to small-scale companies, a subsequent circular was also released,[56] which clarified that the POEM test would not be applied to offshore companies having a turnover or gross receipts of INR 500 million[56] or less.[57] However, since the test is on a turnover basis, only small companies would be removed from the purview of this test and larger start-ups would not qualify, even during the initial loss-generation phase. This test may end up being used as a loophole for tax avoidance structures by providing protection to several holding companies that are used for transactions with India, and that would go against the spirit of the provision.

As noted above, the Final Report of BEPS Action Plan 6 suggests moving away from the POEM test towards a mutual agreement procedure to resolve the problem of dual resident companies, and an option for modifying existing tax treaties along these lines has been

S.P. Govind, India and Its Tryst with Subjective Rules: An Analysis of the Recent Place of Effective Management Guidance, 23 Asia-Pac. Tax Bull. 3 (2017), 8
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A few of India’s important tax treaties (including the India-United States (US) Income Tax Treaty (1989)) do not contain POEM criteria. In fact, in general the India-US treaty does not apply to dual resident entities, and a unilateral declaration by India regarding residence of an otherwise US-resident company may lead to unrelieved double taxation. The possibility of characterization conflicts is particularly alarming, since the mutual agreement procedure generally has not, to date, been a successful remedy in India, and India has rejected the idea of including mandatory binding arbitration in its tax treaties. Since Indian courts are already overburdened, India would need to substantially improve the conduct of the mutual agreement procedure by implementing globally accepted procedural rules or by supplementing it with binding or non-binding procedures.

It is also unclear how India would grant credit for foreign taxes once it chooses to apply the POEM test to an offshore company and whether provisions such as the minimum alternate tax, which are generally applicable to domestic companies, would apply to such companies.

Finally, as to procedure, an assessing officer is also required to obtain prior approval from a commissioner or principal commissioner of income tax before initiating proceedings on POEM and would need to obtain approval from a collegium of three officers at such level.

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before determining that a foreign company is a resident of India under the POEM rules. This is the only instance of added checks and balances in the POEM Guidance and should be considered a welcome change from the draft guidance.

5. Conclusion

In summary, although the POEM Guidance provides some level of clarity and provides some direction in a few situations, it does not provide much to clarify the scope of the legal provision that came into effect on 1 April 2017. The POEM criterion has been interpreted differently by courts around the globe, leading to confusion. However, as is the case with the broadly worded Indian general anti-avoidance rules (GAAR), subjective determinations of these measures by the tax department may lead to increased litigation.

Further, the costs of implementing a framework to monitor the prescribed detailed information to be provided by each company having activities in India seem challenging and one may wonder if more targeted anti-avoidance rules, such as a combination of objective controlled foreign corporation rules and diverted profits tax, along with treaty-abuse provisions implemented through the MLI, may have been more suitable.

Nevertheless, India has signified its preference for subjective measures to tackle abusive tax arrangements. Accordingly, it would also be reasonable to assume that India would seek to add the principal purpose test (PPT) – a broad and subjective general anti-abuse rule – in its tax treaties in the future, via the MLI. It will be interesting to see the list of countries that apply a PPT by way of the MLI, and how India’s tax treaty landscape will change if India ratifies the MLI.

With 2017 bringing significant changes to Indian tax law – with the GAAR and POEM rules now having come into effect – we must wait and see how the domestic law develops.

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70. Which also came into effect on 1 April 2017.
71. Particularly, for the passive income test: see section 3.1.
73. Although India has subscribed to the common reporting standard on automatic exchange of information under the Multilateral Convention on Mutual Administrative Assistance on Tax Matters, as amended by the 2010 Protocol and country-by-country reporting standards under BEPS Action Plan 13, it is yet to be seen how India will establish a framework to accept and process such information.
74. The PPT would be an improvement on India’s GAAR, since the GAAR only allows re-characterization if the “main purpose” of a transaction is a tax benefit, while the PPT allows denial of tax treaty benefits even if “one of the main purposes” is to take advantage of the treaty. The Final Report on BEPS Action Plan 6 provides detailed guidance on how the PPT must be used without allowing much discretion, which would gain interpretive relevance once the MLI comes into effect.
75. The MLI requires signatories to implement either a PPT (along with a simplified limitation on benefits clause or without such a test) or a detailed limitation on benefits clause along with anti-conduit rules. Two countries would need to agree on the choice for it to apply to their treaty, generally. However, if one country wishes to implement the simplified limitation on benefits clause along with their PPT, such change could be one-sided: see article 7 of the MLI.