

Draft Guidance of Place of Effective Management

India has expressed a reservation in the Commentary on the OECD Model as regards the place of effective management, stating that the determination of the place of effective management should be guided by the place where the main and substantial activity of the entity is carried on. This reservation seems to have been taken into consideration when one considers the Indian Draft Guidelines for determining the place of effective management of a company under the Income Tax Act.

1. Introduction

Under the Income Tax Act, 1961 (the ITA), a resident is charged to tax on its income on a worldwide basis. The worldwide basis of taxation is based on the principles of residency as enshrined in the ITA. It is therefore critical that there be certainty as to what the term “resident” means. Residency will not only dictate taxing rights under domestic law and income tax treaties, but may also grant relief to the taxpayer.

Internationally, under the domestic law of various countries, varying tests are prescribed to determine corporate residency, namely the place of incorporation; place of registered office; place of residence of the major shareholders, directors or managers; the place of administration; place of management; principal place of management; place of management and control; location of central management and control; and place of effective management.

The residence status of a person defines the scope of a taxpayer’s taxable income. Under the ITA, a resident is taxable on its worldwide income. A non-resident, on the other hand, is taxable only in respect of income sourced from India or received in India. The scope of taxable income of a non-resident is therefore narrower than that of a resident.

There are two main principles of taxing income: source and residency. Most countries tax income on both a source and residence basis. This means that a resident will be taxed on income derived from both domestic and foreign sources, while a non-resident will be taxed only on income derived from domestic sources.

Instances of double taxation may arise as a result of conflict between the residence jurisdiction and the source jurisdiction. However, there could also be instances where double taxation arises from a resident-resident conflict, where two countries each treat the company as resident for tax purposes under their domestic law. The main purpose of tax treaties is to avoid such double taxation. In order to prevent the double taxation of income of an entity that is regarded as resident in two different countries, the OECD Model Tax Convention (OECD Model) provides a tie-breaker rule that is intended to ensure that the residence of such a dual-resident entity is allocated to the country in which its “place of effective management” is situated. Indian tax treaties have incorporated this concept.

2. International Perspective

The “place of effective management” is an internationally recognized concept for determining the residence of a company. Many countries prefer the place-of-effective-management test as the appropriate test for determination of residence of a company. When considering the interpretations of the term “place of effective management” in other jurisdictions, substantial differences of opinion – in particular between the interpretations given by the continental and non-continental countries – are evident.

Article 4 of the OECD Model¹ uses tie-breaker rules to deal with resident-resident conflicts. Article 4(3) states that “[w]here by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated”. This provision is applicable to companies and other bodies of persons. The Commentary on Article 4 of the OECD Model states that it is not the place where the company is *registered*, but rather the place where the company is *actually managed*, that is to be considered for determination of the place of effective management.

The Commentary also provides that the determination of the place of effective management in cases of dual residency is to be dealt with on a case-by-case basis. This approach is probably the best way to deal with the difficulties in determining the place of effective management of a legal person, especially in today’s world, due to the advances and strides taken in the innovation and the creation of new communication technologies.

The Commentary also defines the place of effective management to mean the place where key management and

* Vispi T. Patel is the founder of Vispi T. Patel & Associates; he has professional experience of more than 30 years in the field of direct tax. Rajiv Shah is a senior advisor with Vispi T. Patel & Associates, Chartered Accountants, Mumbai, India and Kejal Visharia is Associate Consultant with Vispi T. Patel & Associates, Chartered Accountants, Mumbai, India, which provides tax and transfer pricing advisory services. The authors can be reached at vispitpatel@vispitpatel.com; rajivshah@vispitpatel.com; and kejal@vispitpatel.com, respectively.

1. OECD Model Tax Convention on Income and on Capital (26 July 2014), Models IBFD.

commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made. The Commentary further suggests that the place of effective management will ordinarily be the place where the most senior person, or group of people (for example, the board of directors), makes decisions, i.e. the place where the actions to be taken by the entity as a whole are determined. However, the Commentary cautions that there is no one golden rule to determine the place of effective management, and that all relevant facts and circumstances must be examined with reference to each case.

The OECD further establishes that an entity may have more than one place of management, but it may have only one place of effective management at any one point in time. Further, the term "place of effective management" is also used in articles 8, 13(3), 15(3) and 22(3) of the OECD Model as regards the allocation of taxing rights.

Although India is not an OECD member country, it does have observer status. India has expressed some reservation in applying the Commentary on the OECD Model as regards the place of effective management, and has stated that in addition to the above, determination of the place of effective management should also be guided by the place where the main and substantial activity of the entity is carried on. This reservation expressed by India seems to have been taken into consideration when one considers the Draft Guidelines for determining the place of effective management of a company under the ITA. These Guidelines are discussed below.

3. Evolution of the Place of Effective Management: An Indian Snapshot

The rationale for the introduction of the place of effective management under Indian law appears to be, first, to bring more offshore companies (which could be regarded as having their place of effective management in India under tax treaty principles) within the Indian tax net and, second, to bring consistency to the tax residency rules under Indian and international law.

Section 6(3) of the ITA, prior to its amendment by the Finance Act, 2015, provided that a company is said to be resident in India in any previous year, if it is an *Indian company* or if during that year, the *control and management of its affairs* was situated wholly in India. Due to the requirement that the whole of control and management be situated in India, the condition was rendered to be practically inapplicable. A company could easily avoid becoming a resident by simply shifting part of the control and management outside India. Considering this ambiguity, it was desired that this condition be tightened to prevent abuse related to the shifting of the residence of companies effectively managed from India.

In the *Radha Rani Holdings* case,² tax residency in India was potentially avoided merely by diverting a fraction of control and management outside India. The Income

Tax Appellate Tribunal³ held that the stay of a director in India does not render the company a resident of India. The company was registered in Singapore, and one of the two directors was a permanent resident of India. The Tribunal also held that control and management signifies the place where important management decisions are taken, and where the top management of the company manages the business of the company.

In light of the above and the way in which jurisprudence has evolved, the interpretation of the term "wholly in India" was considered to mean fully controlled and managed from India and thus partial management could shift residence. Section 6(3) of the ITA was amended by means of Finance Act, 2015, with effect from 1 April 2016, to provide that a company is said to be resident in India in any previous year, if it is an *Indian company* or if its *place of effective management*, in that year, was in India.

However, by means of the Finance Bill, 2016, the applicability of this amendment has been proposed to be deferred by one year, such that the determination of residence based on the place of effective management will be applicable as from 1 April 2017. Further, it is proposed to insert a new chapter, Chapter XII-BC, which would contain special provisions relating to the taxability of foreign companies regarded as resident in India due to the place of effective management, in order to provide a transitional mechanism.

The term "Indian company" is defined under section 2(26) of the ITA. Further, the term "place of effective management" has been defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made.

The Explanatory Memorandum to the Finance Bill, 2015 stated that a set of guiding principles to be followed in the determination of the place of effective management would be issued for the benefit of both taxpayers and tax authorities.

4. Draft Guidelines

On 23 December 2015, the Central Board of Direct Taxes (CBDT or the Board) finally issued the much awaited draft guiding principles (the Draft Guidelines) which seek to provide guidance on determining the place of effective management for purposes of the residence in India of foreign companies. These Draft Guidelines were open for public comments and suggestions until 2 January 2016. However, at the time of writing this article, the Draft Guidelines have not been finalized.

The Draft Guidelines provide that if the company has an "active business outside India", the company's place of effective management will be presumed to be outside India if the majority of meetings of the company's board of directors are held outside India.

2. IN: ITAT, 31 May 2007, *Radha Rani Holding (P) Ltd v. Additional Director of Income Tax*, 110 TTJ 920.

3. The highest fact-finding authority under the ITA.

4.1. Active business outside India

A company will be said to be engaged in “active business outside India” if:

- its passive income (wherever earned) is 50% or less of its total income; and
- in respect of each of the following, the threshold is less than 50%:
 - its total assets situated in India;
 - its total number of employees situated in India or resident in India; and
 - payroll expenses incurred on such employees compared to total payroll expenditure.

The CBDT needs to provide guidance on certain terms, such as “total assets” and “total income”. Further, there is no clarity as to what the term “payroll expenses” should include or mean, nor as to whether the location where the payroll is processed would be relevant in this context. Difficulties may arise when the Indian parent company deposes its employees to the offshore company. In such a case, when the deputed employee’s payroll amount is transferred to the employee account and cross-charged to its offshore subsidiary, the question arises as to whether the same would be regarded as a payroll expense of the Indian parent company or of the offshore subsidiary company.

For the purpose of determining the place of effective management on the basis of its engagement in active business outside India, the following factors must be considered:

- the place of effective management will be considered to be outside India if the majority of meetings of the company’s board of directors are held outside India. However, if on the basis of facts and circumstances it is established that (i) the board of directors of the company is standing aside and not exercising its powers of management and (ii) such powers are being exercised by either the holding company or any other person(s) resident in India, the place of effective management will be deemed to be in India. This would imply that the primary onus for establishing the place of effective management in India when the majority of the board meetings are held outside India would be on the tax authorities. This could lead to a detailed fact finding exercise being undertaken by field officers of the Indian tax authorities; and
- the average of the data of the previous year and two years prior to that year will be taken into account. If the company has been in existence for a shorter period, data of such period will be considered.

If one needs to ascertain whether 50% of the total assets were outside India, there is no explicit guidance regarding the point in time at which the average must be calculated. As assets and employees are not constant throughout a year, a clarification in that regard would be required. Although the determination of the place of effective management is, admittedly, to be done on a year-to-year basis, the Draft Guidelines likely require that three years’ data be considered, in order to correctly capture the economic substance of the company and bring out the ethos of “substance over form”, which is the guiding spirit of the Guidelines.

4.2. Passive income

The “passive income” of a company is the aggregate of:

- income from the transactions where both the purchase and sale of goods is from or to its associated enterprises; and
- income by way of royalties, dividends, capital gains, interest and rental income.

Chapter X of the ITA, which deals with transfer pricing, covers transactions of purchase and sale of goods between associated enterprises, and such transactions must be reported in Form 3CEB⁴ and documented from an arm’s length perspective. However, if an associated enterprise is found to have a place of effective management in India, it is deemed to become resident in India. Thus, clarity would be required as to whether the associated enterprise would be subject to Indian transfer pricing regulations by virtue of it becoming an Indian resident because of the place of effective management. Further, if the transactions of an associated enterprise (which has a place of effective management in India) and its group companies outside India, are considered to be within the ambit of Indian transfer pricing rules, it would increase the compliance burden of taxpayers to a great extent.

Considering the various initiatives envisaged by the government to promote research and development (e.g. Make in India, Digital India), there could be a case for not regarding royalties as passive income, especially as a large number of Indian companies are heavily investing in the creation of intellectual property rights (IPRs) and this assists the aforementioned government initiatives. According to the Draft National IPR Policy of the Indian government, intellectual property rights are very useful to promote initiatives such as Make in India and Digital India. There could be a situation where an Indian parent company sublicenses its licensed patents to its offshore subsidiary company in order to promote the value of such intellectual property rights to third parties. However, such income from the further licensing of the patents would be covered under the term “active business outside India” and would also be treated as royalty income. Therefore, if royalty income is regarded as passive income, the subsidiary company may lose the advantage of being covered under the term “active business outside India” under the Draft Guidelines.

Further, in the case of companies other than those that are engaged in active business outside India, as mentioned above, the determination of the place of effective management would be a two-stage process,⁵ namely identification of or ascertaining (i) the person or persons who actually make the key management and commercial decisions for conduct of the company’s business as a whole and (ii) the place where these decisions are in fact being made. The place where these management decisions are taken would be more important than the place where such decisions are implemented. Thus, the critical point concerns who makes

.....

4. IN: Report from an accountant to be furnished under section 92E relating to international transaction(s) and specified domestic transaction(s).
 5. Para. 8 Draft Guidelines.

the decision and the location where the decision is taken (rather than where it is implemented).

There is insufficient clarity regarding what would constitute the place where “key management and commercial decisions are in substance made” i.e. whether the residence of directors will be looked at, or the location of board meetings or other criteria such as expansive veto rights by Indian resident shareholders. Key management and commercial decisions do have different meanings in different countries. They relate to policy matters or management or administrative matters. What is the strategic key decision for a trading or manufacturing company, may not be the strategic key decision for a holding or investment company. It would, therefore, be essential to determine, on a case-by-case basis, what comprises crucial decisions for the running of the business. Thus, one must analyse factual, contractual and organizational activities that have a certain degree of significance for the management of the company as a whole, after taking into consideration the nature of the business of the company.

In this context, reference may be made to a South African Circular⁶ that explains management and commercial decisions. Paragraph 4.2.6. (“Operational management versus broader top level management”) of the Circular provides as follows:

Operational management decisions are generally of limited relevance in determining a company’s place of effective management and must be distinguished from the key management and commercial decisions.

Operational management generally concerns the oversight of the day-to-day business operations and activities of a company. Key management and commercial decisions are concerned with broader strategic and policy decisions and tend to be made by members of the senior management team. For example, a decision to open a major new manufacturing facility or to discontinue a major product line would be examples of key commercial decisions affecting the company’s business as a whole. By contrast, decisions by the plant manager appointed by senior management to run that facility, concerning, for example, repairs and maintenance, the implementation of company-wide quality controls and human resources policies, would be examples of operational management.

What constitutes a key management or commercial decision as opposed to an operational management decision is critical as it is the former that is relevant in the context of establishing the place of effective management. Again, this is an aspect that can only be determined on a case-by-case basis. For example, in some businesses the conclusion of each and every contract will be a key commercial decision whereas in other businesses the setting of standardised pricing will be a key commercial decision but the conclusion of individual contracts will not be.

Depending on the particular case, the person responsible for operational decisions may be the same as the person responsible for the key management and commercial decisions. In this situation it is still necessary to distinguish between the two types of decisions and to assess where the key management and commercial decisions are made. The location of this decision-making is critical.

6. ZA: SARS, 26 Mar. 2002, Draft Interpretation Note 6 (Issue 2), *Subject – Resident – Place of Effective Management (Companies)*.

A bare reading of the Commentary on Article 4(3) of the OECD Model will reveal that the concept of place of effective management rests not on the place where a company carries on business activities, but on the place where it takes key management and commercial decisions necessary for the conduct of its business. The definition of “place of effective management” in section 6(3) of the ITA is similar to the OECD definition, which requires identifying what key management and commercial decisions are, whether such decisions are necessary for the conduct of the business, and the place where such decisions are in substance taken.

While enumerating the guiding principles in the Draft Guidelines, it is clarified that the place of decision-making is more important than that of implementation. Furthermore, significance of substance over form is emphasized. Thus, in line with the intention to cover shell companies under this provision, it appears that substance would be given emphasis for determining the place of effective management.

It is also provided that an entity may have more than one place of management, but it may have only one place of effective management at any point of time. As “residence” is to be determined for each year, the place of effective management will also be required to be determined on a year-to-year basis. The process of determination of the place of effective management would be primarily based on the fact as to whether or not the company is engaged in active business outside India.

4.3. Guiding Principles in the Draft Guidelines

The Draft Guidelines provide various principles⁷ to be followed in the above-mentioned two-stage process for the determination of the place of effective management:

4.3.1. *Situs of board meetings*

If the board retains and, in substance, exercises its authority to govern the company and makes the key management and commercial decisions necessary for the conduct of the company’s business as a whole, the place where the board of directors regularly meets and makes decisions may be the company’s place of effective management.

If the key decisions by the directors are taken at a place other than the place where the formal meetings are held, such other place would be relevant for the place of effective management. This may be the case if board meetings are held in a location distinct from the place where the head office of the company is located, or if such location is unconnected with the place where the predominant activity of the company is being carried out.

4.3.2. *Delegation of authority by the board*

If the board of directors has delegated the decision-making authority to senior management⁸ or any other person

7. Para. 8.2 Draft Guidelines.

8. “Senior management” in respect of a company means the person or persons who are generally responsible for developing and formulating

(including shareholder(s)) and routinely ratifies their decisions, the place of effective management will ordinarily be the place of such actual decision-making.

If the board of directors has formally or de facto delegated authority to one or more committees consisting of members of senior management (e.g. executive committee consisting of members of senior management), the place where such a committee develops and formulates key decisions for mere formal approval by the board of directors may be considered to be the place of effective management.

The delegation of authority may be either de jure (by means of a formal resolution or shareholder agreement) or de facto (based upon the actual conduct of the board and the executive committee).

If an Indian parent company's senior manager takes key management and commercial decisions and the offshore subsidiary company's board merely ratifies these decisions, this can create a place of effective management in India.

In a 2001 report, the OECD clarified that:

a test relying solely on where the directors/senior managers or shareholders reside will not always give a clear result. Even a test relying on where the majority of shareholders or directors/senior managers reside may not always result in certainty and may give rise to extreme results where the shareholders are not natural persons.⁹

4.3.3. Location of head office¹⁰

The location of the company's head office is an important factor in the determination of the place of effective management, as it often represents the place where key decisions are made. The head office is defined as the place where the company's senior management and their direct support staff are predominantly located.

If a company is decentralized (e.g. where various members of senior management operate across countries), the head office would be (i) where the senior managers are predominantly based, (ii) the place to which they normally return following travel to other locations or (iii) the place where they meet when formulating or deciding key strategies and policies for the company as a whole. In the case of meetings by way of telephone or videoconferencing, the head office

key strategies and policies for the company and for ensuring the execution and implementation of those strategies on a regular and ongoing basis. While designation may vary, these persons may include Managing Director or Chief Executive Officer, Financial Director or Chief Financial Officer, Chief Operating Officer and the heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

9. OECD, *The Impact of the Communications Revolution on the Application of Place of Effective Management*, discussion paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (OECD 2001), para. 58 (a tie-breaker rule).
10. The "head office" of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.

would normally be the location where the highest level of management (e.g. the managing director and the financial director) and their direct support staff are located.

If senior management is decentralized such that it is not possible to determine the location of the head office with a reasonable degree of certainty, the head office would not be relevant for determining the place of effective management of the company.

4.3.4. Place of implementation or execution of decisions not relevant

The place where management decisions are taken would be more important than the place where such decisions are implemented. Day-to-day routine decisions taken by junior and middle management are not relevant for determining the place of effective management.

4.3.5. Meetings through modern technology

Due to the use of modern technology, the physical location of board meetings, executive committee meetings or meetings of senior management may not be where the key decisions are, in substance, being made. In such cases, the place where the directors or the persons taking the decisions or the majority of them usually reside, may also be a relevant factor.

4.3.6. Secondary factors

If the above factors do not lead to clear identification of the place of effective management, secondary factors may be considered, namely the place where the main and substantial activity of the company is carried out or the place where the accounting records of the company are kept.

In today's modern technological world, accounting records are maintained digitally and can often be accessed from any location. For example, an accounting record is transferred to a person in the United Kingdom who feeds in data and updates the accounting records, and those data are maintained on a server which can be accessed from any location. Thus, the location of maintenance of accounting should be clarified as irrelevant, as it is difficult to trace the location in today's modern technological world.

4.3.7. Factors not relevant or conclusive for determination of the place of effective management

The Draft Guidelines have also emphasized that the determination of the place of effective management is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts. To clarify the above fact, the conditions for establishing a place of effective management in India cannot be said to be satisfied merely because:

- a foreign company is completely owned by an Indian company;
- one or some of the directors of a foreign company reside in India;
- the local management is situated in India in respect of activities carried out by a foreign company in India; or

- there are support functions in India that are preparatory and auxiliary in nature.

Finally, these principles are for guidance only and no single principle will be decisive in itself. A so-called snapshot approach is not to be adopted. Based on facts and circumstances, if it is determined that, during the year, a company has a place of effective management in India and also outside India, the place of effective management will be presumed to be in India if it has been mainly or predominantly in India.

4.3.8. Administrative process

If the assessing officer¹¹ proposes to conclude that there is a place of effective management in India for an offshore company, any such finding may be given by the assessing officer only after seeking prior approval of the Principal Commissioner or the Commissioner, on a case-by-case basis. The Principal Commissioner or the Commissioner must provide the company with an opportunity to be heard before deciding the matter.

5. Clarifications Required

The CBDT needs to clarify the various aspects that may emerge from an offshore company, incorporated outside India, which is deemed to be a resident company of India under the ITA, due to its place of effective management being in India. Examples of such issues include the following:

- In respect of foreign tax credit under section 90 of the ITA (tax treaties), how would India grant relief for taxes paid by such company outside India?
- In respect of a dividend distributed by an offshore subsidiary company to its Indian parent company, would the concessional rate of tax under section 115BBD of the ITA be applicable?
- In respect of dividend distribution tax under section 115-O(1A) of the ITA, payable by an Indian parent company on a dividend distributed by it, would the credit be available for the tax paid by the Indian parent on the dividend received from its offshore subsidiary?
- Under section 115JB of the ITA, where the tax payable on chargeable income of a company is less than 18.5% of its book profit, the book profit is deemed to be the chargeable income of the company and the tax payable would be 18.5% of such book profit (income). This is known as the minimum alternate tax. In the case of such offshore company, would the provisions of section 115JB of the ITA be applicable?
- Would the cumbersome procedural withholding tax provisions under chapter XVIII of the ITA be applicable to such offshore company, as it would find it practically difficult to comply with the provisions?

.....
11. Field Officer.

- Under the ITA, a domestic company is charged to tax on its total income at the basic rate of 30% (as compared to 40% for offshore companies). What would be the rate applicable to such offshore company treated as a resident of India under the place-of-effective-management rules?
- The 2015 Action 6 Final Report under the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) project, “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances”, identifies treaty abuse and, in particular, treaty shopping as one of the most important concerns of the BEPS project (in which India is taking part as an associate). The Report has recommended that countries settle dual-residence conflicts through a mutual agreement procedure (MAP). This will delay MAP proceedings as other foreign countries might not agree with the concept of “active business outside India”.

The Action 6 Final Report has also recommended replacing article 4(3) of the OECD Model (dealing with the place of effective management) by providing that competent authorities of the contracting states should determine the country of residence by mutual agreement, having regard to its place of effective management, place of incorporation or constitution and any other relevant factors.

6. Amendments in Finance Bill, 2016

As mentioned, the concept of deeming a foreign company to be a resident in India if its place of effective management in that year is in India was originally introduced by the Finance Act, 2015, with effect from 1 April 2016. To provide clarity with regard to the implementation of the place of effective management as the basis for a rule of residence for a foreign company that has not been assessed to tax in India, as well a transitional mechanism for such companies, Finance Bill, 2016 (the Bill) has proposed to introduce special provisions (by means of chapter XII-BC) that address issues relating to the applicability of current ITA provisions to a foreign company that has not been an Indian tax resident before the determination of its place of effective management in India. Such companies will be subject to certain conditions as notified by the government.

In order to ensure that there is ease of compliance, the Bill proposes to introduce a “transition mechanism” for a company that is incorporated outside India and has not earlier been assessed to tax in India. It is also proposed that the central government be empowered to notify exceptions, modifications and adaptations, subject to which the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation and its set-off and carry forward and set-off of losses, special provisions relating to the avoidance of tax and the collection and recovery of taxes, will apply.

7. Conclusion

The place of effective management for the purpose of determining the residence status of companies has become of prime importance in today's world – especially with the large strides taken in the innovation and creation of new communication and information technology-related methodologies. In the new age of technology, the old parameters of doing business have been disrupted, often resulting in the erosion of a country's tax base. It is in this context that the place-of-effective-management rules for determining the residence of a company in India are to be visualized.

The concept of place of effective management is not an exact one, but rather an understanding of the way a corporate group operates, and is thus extremely fact-based and dependent upon the reality of the situation prevalent at a particular point in time. The place of effective management is based on the substance of the corporate group prevailing over the mere form of the structure of the group. Thus, it is critical for foreign companies (particularly, overseas joint ventures) and subsidiaries of Indian entities to review their corporate decision-making process. Further, it is also relevant to appropriately document the process and demonstrate adherence thereto in substance at the ground level, in order to mitigate any potential tax risks arising in the tax proceedings.

The place of effective management must be determined based on the facts of each case i.e. after looking into the activities of the foreign company in India as a whole and in substance. The CBDT thus likely needs to (i) clarify the finer points, preferably with examples at the time it releases the final guidelines, and (ii) address the various issues stated above, as well as other nuances which may affect the practical working of an offshore company deemed to be resident in India under the place-of-effective-management rules.

Appendix A

Text of the Draft Guidelines

F. 142/11/2015-TPLGOVERNMENT OF INDIAMINISTRY OF FINANCEDEPARTMENT OF REVENUECENTRAL BOARD OF DIRECT TAXESNEW DELHI

Dated: December 23, 2015

Subject: Draft Guiding Principles for determination of Place of Effective Management (POEM) of a Company.

1. Section 6(3) of the Income Tax Act, 1961, prior to its amendment by the Finance Act, 2015, provided that a company is said to be resident in India in any previous year, if it is an Indian company or if during that year, the control and management of its affairs is situated wholly in India. This allowed tax avoidance opportunities for companies to artificially escape the residential status under these provisions by shifting insignificant or isolated events

related with control and management outside India. To address these concerns, the existing provisions of section 6(3) of the Income Tax Act, 1961 were amended by means of Finance Act, 2015, with effect from 1st April, 2016 to provide that 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.

2. 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.

3. "Place of effective management" (POEM) is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognize the concept of "place of effective management" for determination of residence of a company as a tie-breaker rule for avoidance of double taxation.

4. The Explanatory Memorandum to the Finance Bill, 2015 has stated that a set of guiding principles to be followed in the determination of POEM would be issued for the benefit of the taxpayers as well as the tax administration. Accordingly the guiding principles on the following lines are proposed to be issued.

5. For the purposes of these guidelines:

- (a) A company shall be said to be engaged in "active business outside India" if the 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.
- (b) "Head Office" of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets;
- (c) "Passive income" of a company shall be aggregate of:
 - (i) income from the transactions where both the purchase and sale of goods is from / to its associated enterprises; and
 - (ii) income by way of royalty, dividend, capital gains, interest or rental income;
- (d) "Senior Management" in respect of a company means the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While designation may vary, these persons may include:
 - (i) Managing Director or Chief Executive Officer;
 - (ii) Financial Director or Chief Financial Officer;

- (iii) Chief Operating Officer; and
- (iv) The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

6. Any determination of the POEM will depend upon the facts and circumstances of a given case. The POEM concept is one of substance over form. It may be noted that an entity may have more than one place of management, but it can have only one place of effective management at any point of time. Since "residence" is to be determined for each year, POEM will also be required to be determined on year to year basis. The process of determination of POEM would be primarily based on the fact as to whether or not the company is engaged in active business outside India.

7. The place of effective management in case of a company engaged in active business outside India shall be presumed to be outside India if the majority meetings of the board of directors of the company are held outside India.

7.1 However, if on the basis of facts and circumstances it is established that the Board of directors of the company are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person (s) resident in India, then the place of effective management shall be considered to be in India.

7.2 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.

8. In cases of companies other than those that are engaged in active business outside India referred to in para. 7 the determination of POEM would be a two stage process, namely:

- (i) First stage would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole.
- (ii) Second stage would be determination of place where these decisions are in fact being made.

8.1 The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM it is the substance which would be conclusive rather than the form.

8.2 Some of the guiding principles which may be taken into account for determining the POEM are as follows:

- (a) The location where a company's board regularly meets and makes decisions may be the company's place of effective management provided, the Board
 - (i) retains and exercises its authority to govern the company; and
 - (ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.

It may be mentioned that mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM. As an example this may be the case where the board meetings are held in a location distinct from the place where head office of the company is located or such location is unconnected with the place where the predominant activity of the company is being carried out.

If a board has de facto delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder and does nothing more than routinely ratifying the decisions that have been made, the company's place of effective management will ordinarily be the place where these senior managers or the other person make those decisions.

- (b) A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for mere formal approval by the full board will often be considered to be the company's place of effective management.

The delegation of authority may be either de jure (by means of a formal resolution or Shareholder Agreement) or de facto (based upon the actual conduct of the board and the executive committee).

- (c) The location of a company's head office will be a very important factor in the determination of the company's place of effective management because it often represents the place where key company decisions are made. The following points need to be considered for determining the location of the head office of the company:
 - If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters then that location is the place where head office is located.
 - If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers:
 - (i) are primarily or predominantly based; or
 - (ii) normally return to following travel to other locations; or
 - (iii) meet when formulating or deciding key strategies and policies for the company as a whole.

- Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situation the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located.
 - In situations where the senior management is so decentralised that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's place of effective management.
- (d) It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM.
- (e) The use of modern technology impacts the place of effective management in many ways. It is no longer necessary for the persons taking decision to be physically present at a particular location. Therefore physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.
- (f) If the above factors do not lead to clear identification of POEM then the following secondary factors can 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.
9. It needs to be emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:
- (i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
 - (ii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
 - (iii) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.
 - (iv) The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
10. It is reiterated 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. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly /predominantly in India.
11. Further, in case the Assessing officer proposes to hold a company incorporated outside India, on the basis of its POEM, as being resident in India then any such finding shall be given by the Assessing officer after seeking prior approval of the Principal Commissioner or the Commissioner, as the case may be, in this regard. The Principal Commissioner or the Commissioner shall provide an opportunity of being heard to the company before deciding the matter.
12. The comments and suggestion of stakeholders and general public on the above draft guidance are invited. The comments and suggestions may be submitted by 02nd January, 2016 at the email address (dirtpl1@nic.in) or by post at the following address with "Comments on draft Guidance on POEM" written on the envelop.

Director (Tax Policy & Legislation)-I
 Central Board of Direct Taxes,
 Room No. 147-D,
 North Block,
 New Delhi – 110001