

Final Guidance on Place of Effective Management

The Indian economy has been growing at a relatively fast pace over the last decade and still has the potential to grow. This results in a market that represents an enormous opportunity for global businesses that have responded by swiftly setting up operations in the country, in all sectors of the economy. Local businesses, too, have grown and have begun to aggressively expand their footprint across the world.

1. Introduction

The taxation of a company is usually determined on its residential status in any country. The place of effective management (POEM) is an internationally recognized test to determine the residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognize the concept of POEM to determine the residence of a company as a tie-breaker rule for the avoidance of double taxation. The application of POEM has become of prime importance in today's global scenario, to determine the residential status of companies, where businesses operate globally in a seamless manner. This is particularly the case concerning the large strides taken in the innovation and creation of new communication and information technology-related methodologies.

Under the Indian Income-tax Act 1961 (the ITA), the scope of income tax is determined on the basis of the residential status of a person. In this case, the authors will only deal with the taxation of companies. Section 6(3) of the ITA, determines the residential status of a company.

The residence status of a person defines the scope of a taxpayer's taxable income. The taxation provisions under the ITA extend to both resident and non-resident companies as provided by section 5 of the ITA. A resident company is taxable on its global income; whereas a non-resident company is taxable on income that is received/ deemed to be received in India and on income accrued/deemed to accrue in India. Hence, the residential status of a taxpayer becomes pertinent to determining the scope of income to be taxed within the ambit of the ITA.

The term "Indian company" is defined under section 2(26) of the ITA. Furthermore, 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.

2. Evolution of POEM: An Indian Snapshot

The rationale for introduction of POEM under Indian tax law appears to bring offshore companies (which could be regarded to have a POEM under tax treaty principles in India) into the Indian tax net and also to bring consistency in the tax residency rules under the ITA and the tax treaties.

Section 6(3) of the ITA, prior to its amendment by Finance Act 2015, provided that a company is determined to be resident in India in any financial year (FY), that is, 1 April to 31 March, if it is an Indian company or if during that year, the control and management of its affairs is situated wholly in India. Due to the requirement that the whole of control and management be situated in India, the condition was rendered practically inapplicable. A company could easily avoid becoming a resident of India by simply shifting part of its control and management outside India. Given this ambiguity, it was desired that this condition be restricted to prevent abuse as a result of the shifting of the residence of companies effectively managed from India.

In light of the above and the way jurisprudence has evolved in India, the interpretation of the word "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 thus amended vide Finance Act 2015, with effect from 1 April 2015, to provide that a company is said to be resident in India in any financial year if it is an Indian company or if its place of effective management, in that year, is in India. However, vide Finance Act 2016, the applicability of POEM-based residence test was deferred by one year and was effective from 1 April 2016.

3. Draft Guidelines¹

On 23 December 2015, the Central Board of Direct Taxes (CBDT or the Board)² issued the draft guiding principles (the Draft Guidelines), which provided guidance on determining the place of effective management for purposes of the residence in India of foreign companies. These Draft

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1. See V.T. Patel, R. Shah and K.P. Visharia, *Draft Guidance of Place of Effective Management*, 2016 Intl. Transfer Pricing J. 3 (2016), Journals IBFD.
2. The CBDT is part of the Department of Revenue in the Ministry of Finance of the Indian government.

Guidelines were open for public comments and suggestions until 2 January 2016.

However, the Final Guidelines were not released before March 2016, and hence, the applicability of POEM was deferred by one year and made effective from FY 2016/17, i.e. 1 April 2016.

4. Final Guidelines

The CBDT, on 24 January 2017, issued Circular 6 of 2017, containing the final guiding principles (Final Guidelines) to be taken into account for the determination of the POEM of a foreign company. The Final Guidelines are built on the Draft Guidelines, which were released for public comments by the CBDT.

The CBDT, on 24 January 2017, also issued an official Press Release, which stated that the guidelines for determination of POEM are not meant to target Indian multinational companies having overseas business operations, but to target shell companies and companies that are created for retaining income outside India although real control and management of affairs is located in India. Furthermore, the CBDT also indicated that POEM guidelines will not apply to companies having a turnover or gross receipts of INR 500 million or less in a financial year. However, the Circular issued for the Final Guidelines for determining POEM was silent on this aspect.

In order to remove any doubt, the CBDT vide Circular 8 of 2017 (23 February 2017) clarified that the residency test based on POEM criteria shall not be applicable to a foreign company having a turnover or gross receipts of INR 500 million or less in a financial year.

4.1. POEM for a company engaged in active business outside India

The Final Guidelines provide that if the company has an “active business outside India”, the company’s POEM shall be presumed to be outside India if the majority of meetings of the company’s board of directors (BODs) are held outside India.³

4.1.1. Active business outside India

A company shall be said to be engaged in active business outside India if:⁴

- 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% of:
 - its total assets situated in India;
 - total number of employees situated in India or resident in India; and
 - payroll expenses incurred on such employees compared to total payroll expenditure.

The term “passive income” of a company shall be an aggregate of:

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3. Para. 7 of the Final Guidelines.

4. Id., para. 5.

- income from the transactions where both the purchase and sale of goods is from/to its associated enterprises (AEs); and
- income by way of royalties, dividends, capital gains, interest (excluding interest income earned by banks or public financial institutions, regulated under the laws of the country of incorporation) and rental income.

India is becoming a hub for research and development. As per the Indian government’s Draft National IPR Policy, IPRs are very useful to promote “Make in India” and “Digital India” initiatives. Thus, there are a number of Indian companies that are investing heavily in these activities and developing IPRs and registering patents in India.

Furthermore, many Indian companies are actively engaged in licensing their patents to companies outside India and earning foreign exchange for the country. This could cover a case where the Indian parent company sub-licenses its licensed patents to its offshore subsidiary company for promoting the value of such IPR to third parties. However, such income from further licensing through subsidiaries would not be covered under the term active business outside India, as royalty income is passive income under the Final Guidelines even though in economic essence it is an active business carried out by the subsidiary outside India, as they would also have active senior management who are patent experts. Therefore, if royalty income is considered as passive income, the entire business model of these patent licensing companies may fall through.

Furthermore, an explanation has been added defining the terms, “income”, “value of assets”, “number of employees” and “payroll”.

The term income shall be:

- as computed for tax purposes in accordance with the laws of the country of incorporation; or,
- as per the books of accounts, where the laws of the country of incorporation do not require such a computation.

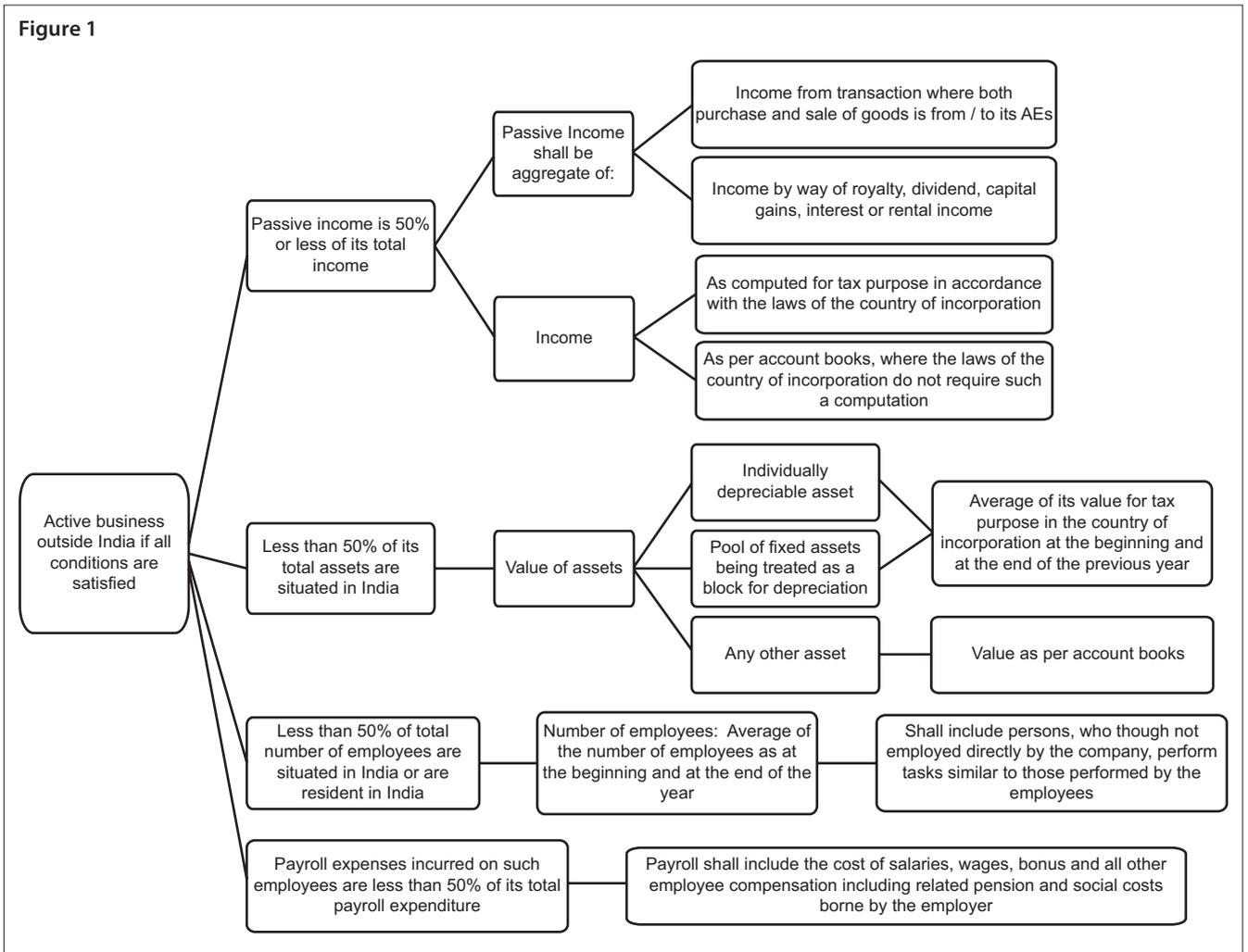
The term value of assets has been defined as:

- in the case of individually depreciable assets and in the case of a pool of fixed assets being treated as a block for depreciation, the average of value for tax purposes in the country of incorporation of the company at the beginning and at the end of the financial year; and
- in the case of any other asset, the value as per the account books.

The term number of employees shall be the average number of employees at the beginning and at the end of the year and shall include persons who, though not employed directly by the company, perform tasks similar to those performed by the employees.

The term payroll shall include the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.

Figure 1



Thus, in essence, to determine whether a company has an active business outside India or not, the conditions shown in Figure 1 must be satisfied.

Furthermore, for the purpose of determining POEM on the basis of its engagement in active business outside India, the following factors also need to be considered:

4.1.2. Data determination for companies engaged in active business outside India⁵

To determine whether the company is engaged in active business outside India, the above conditions are determined by using the average data of the financial year and two years prior to that year. If the company has been in existence for a shorter period, the data of such a period will be considered. The Final Guidelines clarify that in the cases of foreign companies incorporated in jurisdictions where the tax accounting year differs from the Indian financial year, the data of the accounting year that ends during the relevant financial year and the two accounting years preceding it should be considered.

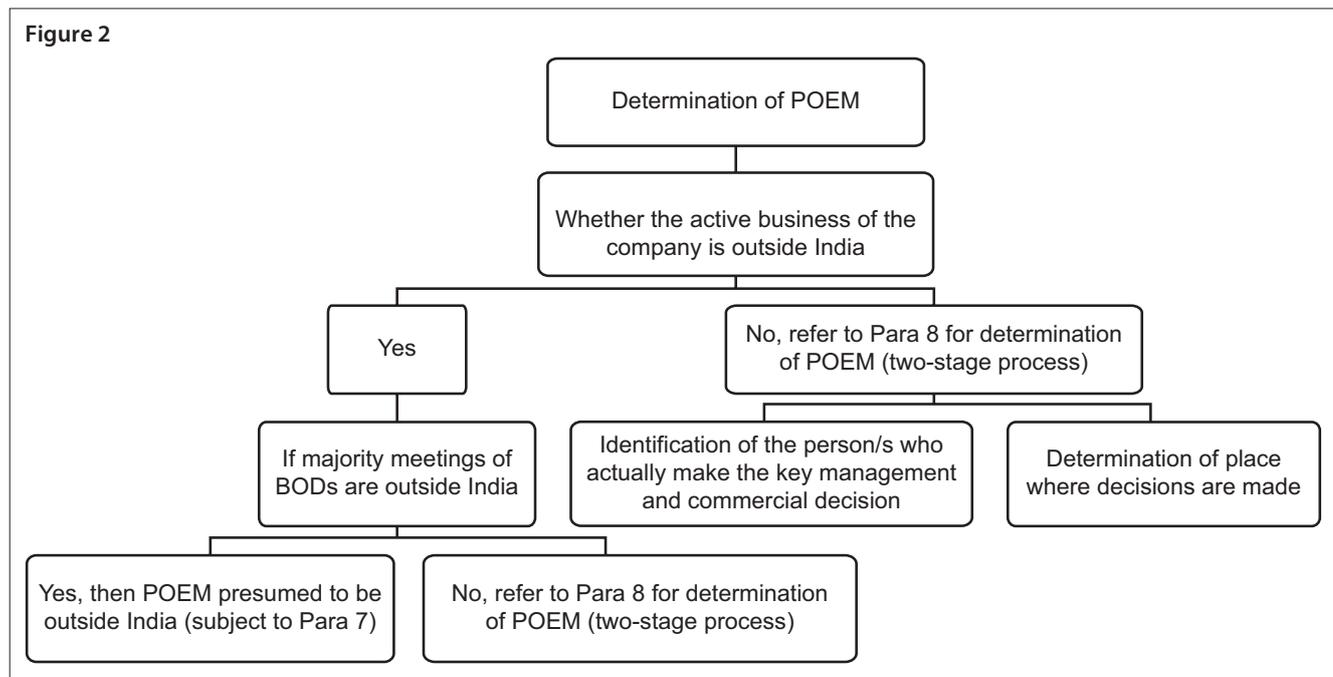
4.1.3. Majority meetings of the Board⁶

As stated earlier, if the company has an active business outside India, the company’s POEM shall be presumed to be outside India if the majority meetings of the board of directors of the company are held outside India. However, it is provided that if the facts and circumstances establish that the board of directors are standing aside and not exercising their powers of management, and that such powers are being exercised by either the holding company or any other person resident in India, the POEM shall be considered to be in India. This would imply that the primary onus for establishing the POEM in India when the majority of board meetings are held outside India would be on the revenue authorities. This could lead to a detailed fact finding exercise being undertaken by the field officers.

Just because the board of directors follow general and objective principles of global policy laid down by the parent entity for the group as a whole, i.e. not for specific entities, this would not imply that the Board is standing aside, i.e. that the board of directors would be considered as not exercising its power. Furthermore, the global policy laid down by the parent entity could be in the field of payroll functions, accounting, human resources, IT

5. Id., para. 7.2.

6. Id., paras. 7 and 7.1.



infrastructure and network platforms, supply chain functions and routine banking operational procedures, etc.

4.2. POEM for other companies – Two-stage process⁷

The position under the Draft Guidelines has been confirmed as regards providing for a two-stage process for determining POEM for companies other than those engaged in active business outside India, as referred to above, that is:

- (1) identification or ascertaining the person or persons who actually make the key management and commercial decisions for conduct of the company’s business as a whole; and
- (2) the determination of the place where these decisions are in fact being made.

It is clear that the place where these management decisions are taken would be more important than the place where such decisions are implemented. What is important is who makes the decision and the location where it is taken rather than where it is implemented. Furthermore, the 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 POEM.⁸

Substance over form⁹

The Final Guidelines are consistent in their emphasis of substance over form and they maintain that determination of POEM will depend on the facts and circumstances of each case. They reiterate that no single guiding principle will be decisive and that activities performed by a foreign company over a period of time will be considered. Furthermore, while the Final Guidelines continue

to eschew a “snapshot approach” based on isolated facts that does not establish effective management to determine POEM, they now explicitly state that the mere existence of a permanent establishment of a foreign company in India would not be conclusive evidence that the conditions for establishing POEM have been satisfied; *see* Figure 2.

4.2.1. Guiding principles

The Final Guidelines provide various principles¹⁰ to be followed in the above-mentioned two-stage process for the determination of POEM:

Situs of the 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 (BODs) regularly meets and makes decisions may be the company’s POEM.
- It is clarified that merely holding formal board meetings at a place would by itself not be conclusive for determination of the POEM being located at that place. If the key decisions by the directors are taken at a place other than the place where the formal meetings are held, such a place would be relevant for the POEM. 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 a location is unconnected to the place where the predominant activity of the company is being carried out.

7. Id., para. 8.

8. Id., para. 8.1.

9. Id., paras. 6, 8.1 and 10.

10. Id., para. 8.2.

Delegation of authority by the board

- If the BOD has de facto (i.e. by control) delegated the decision-making authority to senior management¹¹ or to any other person, including a shareholder, promoter, strategic or legal or financial adviser, etc. and routinely ratifies their decisions, the POEM will ordinarily be the place of such actual decision-making.
- If the BOD has delegated some or all of its authority to one or more committees, such as an executive committee consisting of key members of senior management, the place where the members of the executive committee are based and where that committee develops and formulates key strategies and policies for mere formal approval by the full BOD may be considered to be the POEM.
- 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).

This would cover a situation where an Indian parent company's senior management takes key management and commercial decisions and the offshore subsidiary company's board merely ratifies these decisions. This can create a POEM in India.

Location of head office (HO)¹²

Like the Draft Guidelines, the Final Guidelines also provide that the location of a company's HO would be a very important factor in the determination of the POEM because it often represents the place where key company decisions are made. The HO is defined as the place where the company's senior management and their direct support staff are predominantly located. In this connection, the following points have been provided for determining the location of the head office of the company:

- if the company's senior management and their support staff are based at a single location, which is presented to the public as the company's principal place of business or headquarters, that location is the place where the HO is located;
- if the company is more decentralized (e.g. where various members of senior management operate from time to time from offices in various countries), the HO would be the location:

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11. "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 ongoing basis. While designation may vary, these persons may include the 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).
 12. 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.

- where the senior managers are primarily or predominantly based; or
- the place to which they normally return to following travel to other locations; or
- the place where they meet when formulating or deciding key strategies and policies for the company as a whole;
- if the members of the senior management operate from different locations on a more or less permanent basis and participate in various meetings via telephone/video conferencing, the HO 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;
- where senior management is so decentralized that it is not possible to determine the location of the company's HO with reasonable certainty, the location of the HO would not have much relevance in determining the POEM.

Meetings through modern technology

The Final Guidelines confirm the position under the Draft Guidelines that, due to the use of modern technology, it is no longer necessary for the persons taking decisions to be physically present at a particular location. Therefore, the physical location of board meetings, executive committee meetings or meetings of senior management may not be where the key decisions are substantially 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.

Circular resolution

In the case of circular resolutions or round-robin voting, the factors like the frequency of usage, type of decisions made in that manner and location of parties involved in decision-making would be considered and not merely the location of the proposer of the decision. The place of location of the person who has the authority and exercises such authority to take decisions would also be important. This principle has been recently added in the Final Guidelines.

Shareholder's decision

The Final Guidelines also clarify that merely exercising shareholder powers on matters reserved for shareholder decisions under applicable company law is not relevant for determining the POEM of a company, since their powers do not affect the conduct of the company's business from a management/commercial perspective. Such decisions may include sale of substantial/all assets of the company, dissolution, liquidation, deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares, etc.

However, the shareholders' involvement can, in certain situations, turn into that of effective management through a formal arrangement by way of a shareholders' agreement, etc., or by way of actual conduct. For instance, if shareholders limit the authority of board and senior man-

agers of a company and thereby remove the company's real authority to make decisions, the shareholders' guidance transforms into usurpation, and such undue influence may result in effective management being exercised by the shareholders.

Therefore, whether the shareholders' involvement is crossing the line into that of effective management has to be determined on a case-by-case basis. This principle has also been recently added in the Final Guidelines.

Other factors

It is also clarified that day-to-day routine operational decisions taken by junior and middle management shall not be relevant for the purpose of determining the POEM. Additionally, the Final Guidelines provide clarity on the distinction between operational decisions and strategic/policy decisions. It provides that operational decisions relate to the oversight of the day-to-day business operations and activities of the company, whereas key management decisions are concerned with broader strategic and policy decisions.

Examples of key commercial decisions affecting the company's business as a whole are a decision to open a major new manufacturing facility or to discontinue a major product line. By contrast, examples of routine operational decisions are decisions by the plant manager appointed by senior management to run that facility that concern repairs and maintenance, the implementation of company-wide quality controls and human resources policies. In certain situations, the person responsible for operational decisions may be the same person who is responsible for key management and commercial decisions. In such cases, it would be necessary to distinguish the two types of decision and thereafter assess the location where key management and commercial decisions are taken.

4.2.2. Secondary factors¹³

If the above factors do not lead to clear identification of the POEM, the following secondary factors may be considered, namely:

- the place where the main and substantial activities of the company are 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 that 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 world.

13. Para. 8.3 of the Final Guidelines.

4.3. Factors not relevant or conclusive for determination of the POEM¹⁴

The determination of the POEM is to be based on all relevant facts related to the management and control of the company and not on the basis of isolated facts that, by themselves, do not establish effective management. To elucidate this, some illustrative examples are provided that confirm that the conditions for establishing the POEM in India cannot be said to be satisfied merely because:

- a foreign company is completely owned by an Indian company; or
- a foreign entity has a permanent establishment in India; or
- one or more of the directors of a foreign company reside in India; or
- the local management is situated in India in respect of activities carried out by a foreign company in India; or
- support functions are carried out in India that are preparatory and auxiliary in character.

Finally, these principles are only for guidance 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 its POEM in India and also outside India, the POEM shall be presumed to be in India if it has been mainly/predominantly in India.

4.4. Administrative process¹⁵

It is also stated that if the Assessing Officer¹⁶ (AO) proposes to initiate audit proceedings that the foreign company has its POEM in India, the AO needs to seek prior approval of the Principal Commissioner or the Commissioner, on a case-by-case basis.

The Final Guidelines further provide that if an AO then proposes to hold that a foreign company has its POEM in India, such a finding shall be given by the AO only after seeking the prior approval of a collegium of three members (consisting of the Principal Commissioners or the Commissioners). The collegium so constituted must provide the company an opportunity to be heard before deciding the matter.

4.5. Illustrations¹⁷

The Final Guidelines also provide certain illustrations, which highlight the applicability of certain principles covered in the Guidelines. The illustrations form part of the text of the Final Guidelines attached as Appendix A.

5. Transition Provisions

The determination of POEM is a subjective test, hence, there can be instances where a foreign company is held to be resident in India only following tax assessment/audit

14. Id., para. 9.
 15. Id., paras. 11 and 11.1.
 16. The Field Officer for tax matters.
 17. Para. 12 of the Final Guidelines.

proceedings. If it is so held during audit proceedings, which are posted at the end of the financial year, it would be impossible for the foreign company to comply with the ITA's procedural deadlines for adhering to various compliances, as such a deadline would have passed. Furthermore, in most cases, with the facts remaining the same, the company can be held to be Indian resident for the following tax years too.

To resolve this practical difficulty and to provide for the transitional change of the residential status of a company, a new chapter, Chapter XII-BC (section 115JH) in the ITA was inserted with effect from 1 April 2016, which contains special provisions relating to the taxability of foreign companies regarded as being resident in India due to their POEMs being in India.

Section 115JH of the ITA, inter alia, provides that the Central Government may issue a notification providing exemption, or modification to such companies with regard to computation of income; treatment of unabsorbed depreciation; set-off or carry-forward of losses; collection and recovery of taxes and transfer pricing provisions. The notification shall also provide certain conditions which need to be fulfilled by such a company before it can avail of these relaxations. Furthermore, if such conditions are not met by a company, subsequently the exemptions and modifications would be reversed and the tax officer would have the power to recalculate the income chargeable to tax.

These provisions will apply to those foreign companies that become Indian residents for the first time. Furthermore, if the foreign company is held to be an Indian resident during an audit proceeding, the provisions will also apply to the years subsequent to the first year, until the financial year ending on or before the completion of audit proceeding.

On 15 June 2017, the CBDT issued a Draft Notification (draft notification) vide F No. 370142/19/2017-TPL for exception, modification and adaptation in respect of foreign company said to be resident in India due to the POEM being in India, under section 115JH of the ITA. This draft notification shall be deemed to have come into effect from 1 April 2016.

(I) The draft notification proposes exception, modification and adaptation subject to which, provisions of the ITA relating to computation of total income, treatment of unabsorbed depreciation, set off or carry forward and set off of losses, collection and recovery and special provisions relating to avoidance of tax shall apply to such foreign company who because of its POEM becomes resident in India in any financial year and such foreign company was not assessed as an Indian resident, as under:

- (1) If the foreign company is assessed to tax in the foreign jurisdiction as per the tax record in the foreign country:
 - the written down value (WDV) of the depreciable asset as on the 1st day of the financial year shall be adopted as the opening WDV for the relevant financial year and

- the brought forward loss or unabsorbed depreciation shall be determined year wise as on the 1st day of the financial year in which it is said to be resident in India. The said losses or unabsorbed depreciation shall be deemed to be brought forward on the 1st day and shall be allowed to be set off and carried forward as per the ITA

- (2) If the foreign company is not assessed to tax in the jurisdiction where it is based, then the following values shall be adopted as per the books maintained in accordance with the laws of that foreign jurisdiction:
 - the WDV of the depreciable asset and
 - the brought forward loss or unabsorbed depreciation as on the 1st day of the financial year in which it is said to be resident in India. The said losses or unabsorbed depreciation shall be deemed to be brought forward on the 1st day and shall be allowed to be set off and carried forward as per the ITA
- (3) In a case where the accounting year does not end on March 31, the foreign company shall be required to prepare profit and loss account and balance sheet:
 - for the period starting from the date on which the accounting year immediately following the said accounting year begins, to March 31 of the year immediately preceding the period beginning with April 1 and ending on March 31 during which the foreign company has turned resident, and
 - for succeeding periods of twelve months, beginning from April 1 to March 31, till the year the said foreign company remains resident in India on account of its POEM.

Example:

Scenario 1: A foreign company turns resident on account of its POEM in India in FY 2016 - 17 and the accounting year ends on December 31, 2016, then the foreign company shall be required to prepare the profit and loss account and balance sheet for the period January 1, 2016 to March 31, 2016.

Scenario 2: A foreign company turns resident on account of its POEM in India in FY 2016 - 17 and the accounting year ends on June 30, 2016, then the foreign company shall be required to prepare the profit and loss account and balance sheet for the period July 1, 2015 to March 31, 2016.

- (4) In a case of carry forward of loss, where the accounting year does not end on March 31; the period starting from the date on which the accounting year immediately following the said accounting year begins to March 31 of the year immediately preceding the period beginning

with April 1 and ending on March 31 during which the foreign company has turned resident is:

- less than six months, it shall be included in that accounting year;
- equal to or more than six months, then that period shall be treated as a separate accounting year.

Example:

Scenario 1: A foreign company turns resident on account of its POEM in India in FY 2016 - 17 and the accounting year ends on December 31, 2016, then the foreign company shall be required to prepare the profit and loss account and balance sheet for the period January 1, 2016 to March 31, 2016. However, this period is less than six months as noted above, hence, the foreign company will have to prepare its accounts from the period January 1, 2015 to March 31, 2016.

Scenario 2: A foreign company turns resident on account of its POEM in India in FY 2016 - 17 and the accounting year ends on June 30, 2016, then the foreign company shall be required to prepare the profit and loss account and balance sheet for the period July 1, 2015 to March 31, 2016, since this period is more than six months, as noted above, the period would remain the same for preparation of accounts.

- (5) Where more than one provision of Chapter XVII-B of the ITA [relating to deduction of tax at source (TDS)/ withholding tax] applies to the foreign company both in the status of a foreign company and as a resident in India on account of its POEM, it is proposed that the provision as applicable to the foreign company shall apply.
- (6) Section 195(2) of the ITA (relating to application to Assessing Officer for lower rate of TDS) shall apply in such manner so as to include payment to the foreign company.
- (7) Once the foreign company is held to be resident in India on account of its POEM in India, it shall be entitled to relief or deduction of taxes paid as per section 90 (agreement with foreign countries – Bilateral relief under the Double Tax Avoidance Agreement) or section 91 (countries with which no agreement exists – Unilateral relief) of the ITA.
- (8) The rate of exchange for conversion of foreign currency into rupees, wherever applicable, shall be as per Rule 115¹⁸ of the Income-tax Rules, 1962.

(II) The above exceptions, modifications and adaptations shall be applicable:

- where a foreign company is said to be resident in India in any financial year on account of its POEM being in India and
- where such foreign company was not resident in India in any of the financial years preceding the said financial year,

then for the purposes of taxation of said foreign company; all transactions of the said foreign company with any other person or entity under the ITA shall not be altered only on the ground that the said foreign company has turned resident on account of its POEM being in India.

(III) Further, subject to the above, the foreign company shall continue to be treated as a foreign company even if it is said to be resident in India on account of its POEM being in India, and all the provisions applicable to a foreign company shall apply accordingly. However, the provisions applicable to a company resident in India will apply.

Thus, the rate of income-tax in case of foreign company (i.e. 40%) shall remain the same, even though the residential status of the foreign company changes from non-resident to resident on the basis of POEM.

6. Conclusion

The concept of POEM is not an exact science but rather an understanding of the way a corporate group operates. It is thus extremely fact based and dependent upon the situation prevalent at a particular point of time, for determination of the POEM.

The POEM is based on the philosophy of substance of the corporate group prevailing over the mere form of the structure of the group. Hence, it is important for foreign companies, particularly for overseas joint ventures, or subsidiaries of Indian entities, to review the corporate decision-making process. Furthermore, it is also relevant to appropriately document the process and demonstrate adherence thereto in substance at the ground level to mitigate any potential tax risks arising in the tax proceedings.

The Final Guidelines are similar to the Draft Guidelines, only providing implicit clarity on certain issues. It is not the intention to target Indian multinationals that are engaged in business activity outside India. The intention is rather to target shell companies and companies that are created for retaining income outside India although real control and management of affairs is located in India. It is emphasized that these guidelines are not intended to apply to foreign companies, or to tax their global income, merely on the grounds of the presence of a PE or business connection in India.

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18. Rule 115 of the Income-tax Rules 1962 provides a rate of exchange for the conversion of income expressed in foreign currency into rupees.

Appendix A

Text of Final Guidelines

GOVERNMENT OF INDIA

MINISTRY OF FINANCE

DEPARTMENT OF REVENUE

CENTRAL BOARD OF DIRECT TAXES

NEW DELHI

CIRCULAR NO 6/2017, Dated: January 24, 2017

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

Section 6(3) of the Income-tax Act, 1961 (the Act), 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 Act were amended vide 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. "Place of effective management" is defined in the Act 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.

3. The Finance Act, 2016 has changed the effectivity of the said amendment to section 6(3) of the Act. Therefore, the amended provision would now be effective from 1st April 2017 and will apply to Assessment Year 2017-18 and subsequent assessment years.

4. '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 recognises the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. The guiding principles to be followed for determination of POEM are enumerated in the following paragraphs.

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.

Explanation: For the aforesaid purpose,

- (A) the income shall be,
 - (a) as computed for tax purpose in accordance with the laws of the country of incorporation; or
 - (b) as per books of account, where the laws of the country of incorporation does not require such a computation.
 - (B) the value of assets,
 - (a) in case of an individually depreciable asset, shall be the average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the previous year; and
 - (b) in case of pool of a fixed assets being treated as a block for depreciation, shall be the average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the year;
 - (c) in case of any other asset, shall be its value as per books of account;
 - (C) the number of employees shall be the average of the number of employees as at the beginning and at the end of the year and shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees.
 - (D) the term "pay roll" shall include the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.
- (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; However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation.

(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. For this purpose, merely because the Board of Directors (BOD) follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of Pay roll functions, Accounting, Human resource (HR) functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; would not constitute a case of BOD of companies standing aside.

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. Where the accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the previous year, then, data of the accounting year that ends during the relevant previous year and two accounting years preceding it 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, promoter, strategic or legal or financial advisor etc. 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) 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.
- (e) In case of circular resolution or round robin voting the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered. It cannot be said that proposer of decision alone would be relevant but based on past practices and general conduct; it would be required to determine the person who has the authority and who exercises the authority to take decisions. The place of location of such person would be more important.
- (f) The decisions made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's place of effective management. Such decisions may include sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. These decisions typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company's business from a management or commercial perspective and are therefore, generally not relevant for the determination of a company's place of effective management.
- However, the shareholder's involvement can, in certain situations, turn into that of effective management. This may happen through a formal arrangement by way of shareholder agreement etc. or may also happen by way of actual conduct. As an example if the shareholders limit the authority of board and senior managers of a company and thereby remove the company's real authority to make decision then the shareholder guidance transforms into usurpation and such undue influence may result in effective management being exercised by the shareholder.
- Therefore, whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only.
- (g) 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. The operational decisions relate to the oversight of the day-to-day business operations and activities of a company whereas the key management and commercial decision are concerned with broader strategic and policy decision. 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 repairs and maintenance, the implementation of company-wide quality controls and human resources policies, would be examples of routine operational decisions. In certain situations it may happen that person responsible for operational decision is the same person who is responsible for the key management and commercial decision. In such cases it will be necessary to distinguish the two type of decisions and thereafter assess the location where the key management and commercial decisions are taken.

8.3 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 there exists a Permanent Establishment of a foreign entity in India would itself not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- (iii) 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.
- (iv) 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.
- (v) 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. The Assessing Officer (AO) shall, before initiating any proceedings for holding a company incorporated outside India, on the basis of its POEM, as being resident in India, seek prior approval of the Principal Commissioner or the Commissioner, as the case may be.

11.1 Further, in case the AO 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 AO after seeking prior approval of the collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to

be constituted by the Principal Chief Commissioner of the region concerned, in this regard. The collegium so constituted shall provide an opportunity of being heard to the company before issuing any directions in the matter.

12. Illustrations:

The following are certain illustrations intended to highlight applicability of certain principles enumerated in the foregoing paragraphs of the guidelines. The facts assumed have been simplified to highlight the principle. Actual determination of POEM of a company shall depend on all relevant facts.

Example 1: Company A Co. is a sourcing entity, for an Indian multinational group, incorporated in country X and is 100% subsidiary of Indian company (B Co.). The warehouses and stock in them are the only assets of the company and are located in country X. All the employees of the company are also in country X. The average income wise breakup of the company's total income for three years is,

- (i) 30% of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises;
- (ii) 30% of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises;
- (iii) 30% of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises; and
- (iv) 10% of the income is by way of interest.

Interpretation: In this case passive income is 40% of the total income of the company. The passive income consists of,

- (i) 30% income from the transaction where both purchase and sale is from/to associated enterprises; and
- (ii) 10% income from interest.

The A Co. satisfies the first requirement of the test of active business outside India. Since no assets or employees of A Co. are in India the other requirements of the test is also satisfied. Therefore company is engaged in active business outside India.

Example 2: The other facts remain same as that in Example 1 with the variation that A Co. has a total of 50 employees. 47 employees, managing the warehouse, storekeeping and accounts of the company, are located in country X. The Managing Director (MD), Chief Executive Officer (CEO) and sales head are resident in India. The total annual payroll expenditure on these 50 employees is of Rs. 5 crore. The annual payroll expenditure in respect of MD, CEO and sales head is of Rs. 3 crore.

Interpretation: Although the first limb of active business test is satisfied by A Co. as only 40% of its total income is passive in nature. Further, more than 50% of the employees are also situated outside India. All the assets are situated outside India. However, the payroll expenditure in respect of the MD, the CEO and the sales head being employees resident in India exceeds 50% of the total payroll expen-

diture. Therefore, A Co. is not engaged in active business outside India.

Example 3: The basic facts are same as in Example 1. Further facts are that all the directors of the A Co. are Indian residents. During the relevant previous year 5 meetings of the Board of Directors is held of which two were held in India and 3 outside India with two in country X and one in country Y.

Interpretation: The A Co. is engaged in active business outside India as the facts indicated in Example 1 establish. The majority of board meetings have been held outside India. Therefore, the POEM of A Co. shall be presumed to be outside India.

Example 4: The facts are same as in Example 3 but it is established by the Assessing Officer that although A Co.'s senior management team signs all the contracts, for all the contracts above Rs. 10 lakh the A Co. must submit its recommendation to B Co. and B Co. makes the decision whether or not the contract may be accepted. It is also seen that during the previous year more than 99% of the contracts are above Rs. 10 lakh and over past years also the same trend in respect of value contribution of contracts above Rs. 10 lakh is seen.

Interpretation: These facts suggest that the effective management of the A Co. may have been usurped by the parent company B Co. Therefore, POEM of A Co. may in such

cases be not presumed to be outside India even though A Co. is engaged in active business outside India and majority of board meeting are held outside India.

Example 5: An Indian multinational group has a local holding company A Co. in country X. The A Co. also has 100% downstream subsidiaries B Co. and C Co. in country X and D Co. in country Y. The A Co. has income only by way of dividend and interest from investments made in its subsidiaries. The Place of Effective Management of A Co. is in India and is exercised by ultimate parent company of the group. The subsidiaries B, C and D are engaged in active business outside India. The meetings of Board of Director of B Co., C Co. and D Co. are held in country X and Y respectively.

Interpretation: Merely because the Place of Effective Management of an intermediate holding company is in India the POEM of its subsidiaries shall not be taken to be in India. Each subsidiary has to be examined separately. As indicated in the facts since companies B Co., C Co. and D Co. are independently engaged in active business outside India and majority of Board meetings of these companies are also held outside India. The POEM of B Co., C Co. and D Co. shall be presumed to be outside India.

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