



**AKG ADVISORY LLP**

Corporate and Legal Consultancy Firm

# Place of Effective Management

## ‘PoEM’



Analysis Study

## 1. BACKGROUND AND ISSUES

The Finance Act, 2015 introduced the concept of PoEM to determine the residency of a foreign company for tax purposes. A foreign company is a company incorporated outside India.

PoEM is an internationally recognized test for determination of residence of a company incorporated in a foreign country. Countries like Germany, China, Switzerland, South Africa, Italy etc. already use PoEM as one of the criteria for determining place of residence of a company. According to the residence article in the OECD Model Convention, PoEM is used as a tie-breaker rule for resolving the problem of dual residency under tax treaties.

The provisions stipulate that a foreign company would be considered resident in India if its PoEM in that year is in India. In contrast, the erstwhile provisions provided that a foreign company would be treated as resident in India only if it was 'wholly' controlled and managed in India. The implications of such a provision were that a foreign company being effectively managed and operated in India could still avoid Indian taxes by shifting insignificant or small management functions outside India. In order to counter such tax avoidance, the requirement of 'wholly controlled and managed in India' has been done away with and concept of PoEM has been introduced whereby effective management in India would be sufficient to treat a foreign company as resident in India and cover it under the Indian tax umbrella. PoEM provisions apply to companies having turnover or gross receipts not less than Rs 50 Crores in a financial year.



However, in the case of a company incorporated outside India (foreign company), it is relevant to consider the place from where the company is being effectively managed. In the age of globalisation and digitization, it is easy to have the place of incorporation and place of management in different countries. Thus, for a foreign company having any links with India, its PoEM will have to be determined to determine its residence for tax purposes.

The main categories of companies which could get impacted by PoEM provisions are:

Foreign subsidiaries of Indian companies	Foreign companies having subsidiaries in India	Special Purpose Vehicles or Joint Ventures opened by Indians for foreign projects
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This is because it is in the case of these entities that nexus of management to India exists in some way or the other. The PoEM provisions have significant ramifications because when a foreign company's PoEM during a year is established in India, its global income for that year will be taxable in India at Indian rates of tax. In contrast, a company which is nonresident will be liable to be taxed only on income sourced (earned) in India.

## Legislation

**1.1** Section 6(3) of the Act defines PoEM as the “place where the key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made”.

Thus, PoEM is the place where:

- (I) Key management and commercial decisions;
- (ii) Necessary for the conduct of the business of the entity as a whole;
- (iii) Are, in substance, made

**1.2** The Ministry of Finance, Government of India had issued administrative guidance to assist in the determination of PoEM and invited comments on the same from stakeholders and general public. On January 24, 2017, final guidelines ('guidelines' or 'guiding principles') on PoEM were released by the government with more clarifications. The guidelines explain the meaning of 'PoEM' as the 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.



Further, guidance for determination of PoEM was provided in the Guiding Principles for determination of PoEM of a company dated 24th January, 2017 issued by CBDT.

The objective of this literature is to set out the background facts pertaining to entity registered outside India and also set out the tax implications on the entity under the “Guiding Principles of Place of effective management of company”.

## 2. CRITICAL DO'S AND DON'TS FROM PoEM PERSPECTIVE

**2.1** PoEM provisions apply to companies having turnover or gross receipts of more than Rs 50 Crores in a financial year.

### Active Business

**2.2** If the entity fulfills all the conditions for 'active business outside India', therefore this greatly tilts the balance in favour of a presumption that PoEM is outside India.

**2.3** Further, in case of a company engaged in active business outside India, PoEM shall be presumed to be outside India if the majority of meetings of the board of directors of the company are held outside India. Moreover, proper minutes of the Board meetings must be maintained in order to show the nature of decisions taken during the meeting.

**2.4** However, the above presumption is a rebuttable presumption. Therefore, if tax department finds evidence on 'Key Management and Commercial Decisions' for foreign entity being taken from India, PoEM provisions may still apply. To safeguard against this, following precautions must be observed.

### Head Office

**2.5** The entity must ensure that the Head Office (where all the Senior Management Personnel of the company work) must be established in a place outside India (usually in the country of incorporation).

### Senior Management Personnel

**2.6** The entity should ensure that majority, if not all, of the Senior Management Personnel (including Directors) who take the key management and commercial decisions should be residents abroad.

**2.7** Senior Management Personnel (including Directors) who are resident in India must NOT be the ones taking the key management and commercial decisions. If they do take key management and commercial decisions, it must be ensured that they do so mostly when they are traveling abroad. In this regards, proper documentary evidence of this must be maintained like tickets, hotels bills etc.

**2.8** Non-resident directors should be entrusted with Senior Management functions such as Finance, Policy formulation, procurement, etc. and also their designations (Managing Director, Finance director etc.) should reflect the same.

### Books of Accounts

**2.9** The entity should ensure that all books of accounts (like financial statements, bookkeeping, etc) should be maintained with the local Accountant in overseas or in the Company's Head Office.

**2.10** As a measure of precaution, Company should maintain proper documentary evidence in relation to above activities. For example, maintaining proper minutes of meetings in order to show the actual exercise of power by the Board, travel records of all the senior management when they are participating in the meeting etc.

2.11 It must be noted that determination of PoEM is not based on a one-off event or by viewing events in isolation. Instructions given from India once in a while or one Board meeting taking place in India or residence of one of the Senior Management Personnel in India when majority of the other Senior Management Personnel reside in the country of incorporation, will not, by itself, make the PoEM of the company in India. Activities performed over the entire year are to be considered and a subjective analysis will be required to be done to determine PoEM of a foreign company.

### 3. POEM PROVISIONS EXPLAINED

3.1 The three constituents of PoEM as listed above are explained as follows:

(i) Key management and commercial decisions has not been defined in the guidelines or in the amended section. However, in this regard, high importance has been given to the location of 'Senior Management' of the company, who have been defined as the person(s) who are generally responsible for developing and formulating key strategies and policies for the company, and ensuring or overseeing the execution or implementation of those strategies on a regular and on-going basis. Senior Management may include following persons (by whatever designation known):

- a) Managing Director or Chief Executive Officer
- b) Financial Director or Chief Financial Officer
- c) Chief Operating Officer

d) Heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing)

(ii) Only the key management and commercial decisions that are necessary for the conduct of the business of the entity as a whole are relevant for PoEM purposes. Such decisions are in the nature of major strategic or policy decisions, for eg. relating to the direction that the company has to take, strategic alliances or joint ventures the Company may enter into, a major new factory to be opened, whether or not to discontinue a major product line etc. Day to day routine operational decisions undertaken by junior and middle management are not relevant for the purpose of determination of PoEM. It is the place where the decisions necessary for conduct of the business of the entity as a whole are taken that is relevant in determining PoEM. Thus, it is necessary to analyse the decisions taken by senior personnel, identify the key management and commercial decisions and then identify the location where such decisions are taken, in order to determine the PoEM. In many cases, persons taking routine operational decisions may be the same persons taking the key management and commercial decisions.

(iii) The place where the above-explained key management and commercial decisions are in substance made is perhaps the most critical factor for deciding the PoEM of a company. In this context, the location where a company's Board regularly meets and makes decisions may be the company's PoEM.

However, if the Board has, by a formal resolution or by practice, delegated the authority to make the key management and commercial decisions for the company to the senior management, an executive committee 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 PoEM will ordinarily be the place where these senior managers, executive committee or the other person(s) make those decisions.

**3.2** In such a scenario, location of the company's head office will be a very important factor as Head Office is where the Senior Management is usually located and key company decisions made. For determining the location of the Head Office of the company, following points are important:

- 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 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.

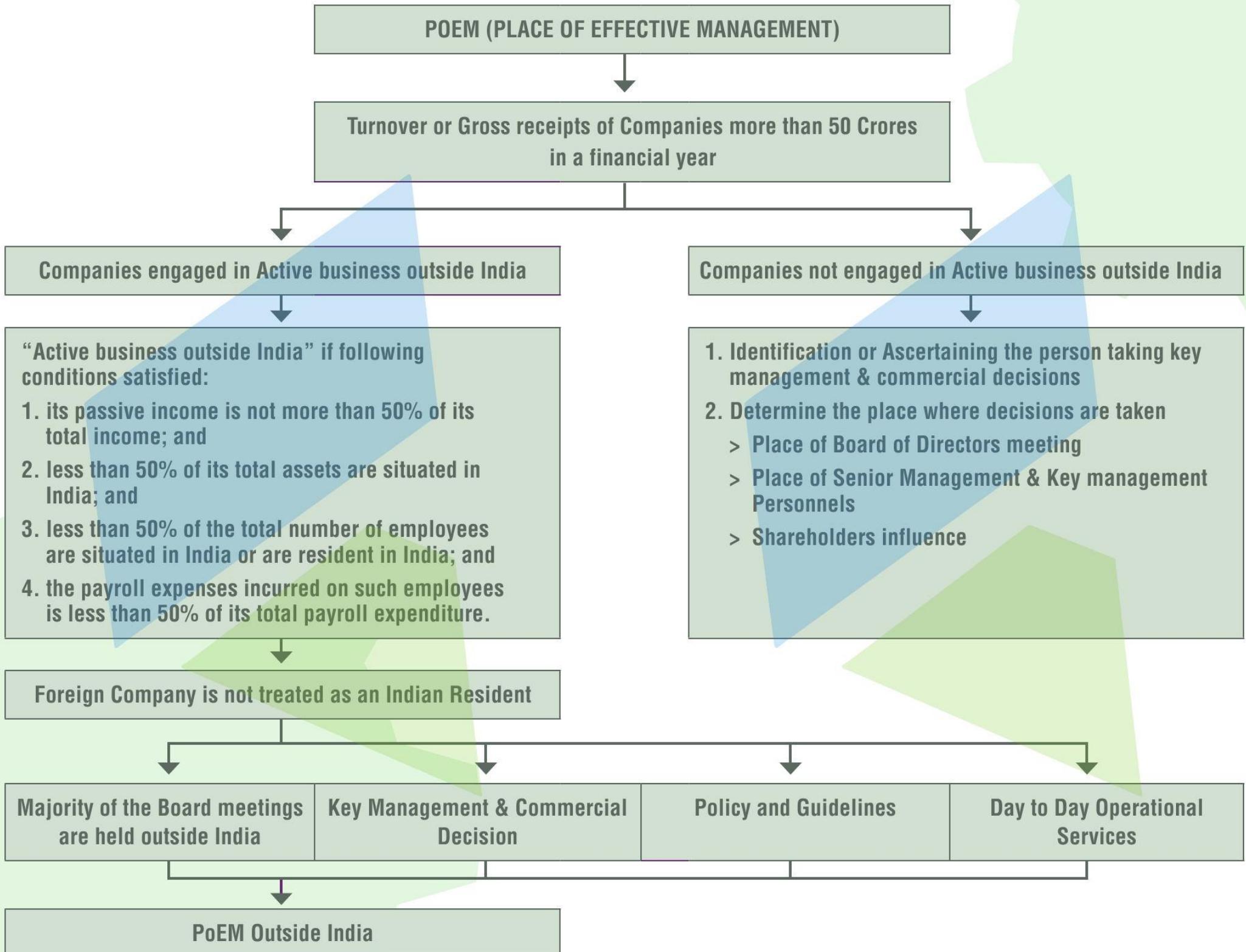
- Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situations, the head 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 PoEM.

**3.4** Thus, the place where the decisions are actually and in substance made and not the place where decisions are merely ratified, approved or implemented will be relevant for PoEM purposes.

### **Companies Engaged in Active Business outside India**

**3.4** A company is said to be engaged in active business outside India, if all of the following conditions are satisfied:

- I) If its passive income is not more than 50% of its total income. [Passive income is the aggregate of:
  - (a) Income from transactions where both purchase and sale of goods is from/to associated enterprises; and



(b) Income by way of royalty, dividend, capital gains, interest or rental income. However, interest income in case of a company engaged in banking or a public financial institution is not to be considered as passive income]

- ii) Less than 50% of its total assets are situated in India; and
- iii) Less than 50% of total number of employees are situated in India or are resident in India; and
- iv) Payroll expenses incurred on such employees is less than 50% of the total payroll expenditure of the company

**3.5** If any of the above conditions is not satisfied, the company would not be considered to be engaged in active business outside India. Further, data of the previous year under consideration and that of two years prior to that shall be averaged to determine whether the company is engaged in active business outside India. Thus, for example, if the data for the previous year satisfies the conditions of active business outside India, but the average of the data of three years does not satisfy the conditions, then the company shall not be said to be engaged in active business outside India.

**3.6** For a company engaged in active business outside India, **its PoEM shall be presumed to be outside India if the majority of the meetings of the Board of Directors are held outside India<sub>9</sub>. However, peculiar facts may still lead to the conclusion that the effective management for such a company is being exercised from India, in which case the PoEM will not be presumed to be outside India<sub>10</sub>.**

If the majority of Board meetings are held in India, then even for a company engaged in active business outside India, PoEM will not be automatically presumed to be outside India.

**3.7** However, the guidelines make it clear that the concept of PoEM is one of substance over form. The guidelines go on to provide that if from the facts and circumstances it is established that the Board of Directors 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 or persons, then location of such holding company or person(s) shall be considered for determining the PoEM. However, the guidelines are silent as to who bears the burden of proving that the Board of Directors is/ is not exercising its powers. Will all companies be required to prove that their Board is actually exercising its powers and not standing aside? Or in only such cases where the tax authorities suspect that the Board may not be exercising its powers and ask companies on a caseby-case basis to prove otherwise? These questions are left unanswered in the guidelines. Still, as a measure of precaution, companies should keep evidence such as maintaining proper minutes of meetings in order to show the actual exercise of powers by the Board.

**3.8** For the purpose of considering whether a foreign entity is engaged in active business outside India, its income from the transactions with Associated Enterprise ('AE'), along with income from royalty, dividend, capital gains, interest or rental income, will together constitute the passive income of foreign entity. The percentage of such

passive income out of the total income of foreign entity. will then need to be determined. If it exceeds 50% of the total income, then entity. may be said to be engaged in active business outside India, depending upon satisfaction of the other conditions as regards total assets, residence of employees and payroll expenses on Indian employees.

### **Companies NOT Engaged in Active Business outside India**

**3.9** For companies not engaged in active business outside India, the determination of PoEM is a two stage process:

- (i) Identification or ascertaining of the person or persons who actually make the key management and commercial decisions for conduct of the company's business as a whole.
- (ii) Determination of the place where these decisions are, in substance, made.

**3.10** The place where these decisions are taken is more important than the place where such decisions are implemented. The following factors are considered for determination of PoEM

- i) Place of Board of Directors Meeting
- ii) Place of Senior Management and Key Management Personnels;
- iii) Shareholders influence

**3.11** Finally, if after considering the location of Board meetings, location of Senior Management Personnel, and shareholders' influence, the PoEM of the company is still

not clearly identifiable, the following secondary factors could be considered:

- (a) Place where main and substantial activity of the company is carried out; or
- (b) Place where the accounting records of the company are kept.<sup>11</sup>

**3.12** However, it is reiterated that these factors should only be resorted to if PoEM is not identifiable through methods explained earlier.

### **4. STEPS TO ENSURE THAT A FOREIGN COMPANY IS NOT TREATED AS AN INDIAN RESIDENT**

#### **Board Meetings**

- For companies engaged in active business outside India, the place where majority of the Board meetings are held is the most important criterion for determination of PoEM.
- The board must retain and exercises its authority to govern the company
- The board must make the key management and commercial decisions necessary for the conduct of the company's business as a whole.
- As far as possible, Board meetings should not be held in India and no key management and commercial decisions should be taken from India.
- Number of Board meetings in which key management personnel participate from India through video- or tele-conferencing should be minimized.

**Note:** The company should maintain proper Minutes books wherein the deliberations undertaken during the Board meetings are documented and recorded appropriately in order to prove the nature of decisions taken during those meetings.

## Section A – Key Management and Commercial Decision

In order to mitigate the exposure on PoEM in India, it is important to identify or ascertained the person or persons who actually make the key management and commercial decisions for the conduct of the company's business as a whole. Also, it is important to determine the place where these decisions are, in substance made.

### (I) Head Office and Senior management Personnel:

- “Head Office” of a company would be the place where the company's senior management and their direct staff are located.
- If they are located at more than one location, the “Head Office” would be 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.
- Establishing a Head Office where the Senior Management Personnel of the company would work and take decisions necessary for the conduct of the entire business of the entity as a whole is an important factor which can determine the PoEM.

- 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 situations, 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.**
- Having an office outside India is not sufficient to escape establishment of PoEM in India. As far as possible, the foreign company should ensure that the majority, if not all, of its Senior Management Personnel (or Key Management Personnel) who take the key management and commercial decisions make such decisions when they are outside India (usually at the Head Office).
- It will be better if these directors are also residing in the same country where the foreign company's PoEM is to be situated, because in case the location where key management and commercial decisions are taken is not determinable with certainty, the place of residence of the Senior Management Personnel may become the deciding factor<sup>13</sup>. Costs and administrative inconvenience may increase on account of moving the residence of key personnel from India to another country, but it will be beneficial from the point of view of keeping the PoEM of the company outside India.
- Professional directors like CAs and bankers do not qualify as part of Senior Management Personnel exercising

effective management. The directors should be genuine businessmen/ professional who would actually conduct the business of the company.

- The taking of key management or commercial decisions should be properly documented with details of the person(s) taking them and the place where they are taken.

## **(II) Shareholders' Meetings**

- Whether or not Shareholders' meetings should be held outside India depends on whether or not shareholders are taking key management and commercial decisions. Location of shareholders' meetings will not be important if shareholders are only taking decisions on matters which are reserved for shareholder decisions under company law and not really taking any key decisions for the company.
- However, where shareholders' involvement, either by conduct or through formal shareholder agreement, increases to such an extent that the authority of senior management personnel is limited and key management and commercial decisions are taken by the shareholders, then it may be treated by tax authorities as usurpation of company's powers by shareholders and in that case shareholders' influence/location will become a relevant factor for determination of PoEM. Extent of shareholders' influence is a question of fact and will be judged on case-to-case basis.<sup>15</sup>

## **Section B – Policy and Guidelines**

### **(III) Extent of Parent Company Support**

The parent company's influence on subsidiary should only be in the capacity of majority shareholder to protect its interest and restricted to only giving visionary direction to its business and should not extend to the actual handling of the subsidiary's key activities.

### **(IV) Electronic Instructions:**

- While formally a Board of Directors may meet outside India, Indian shareholders should not be in the habit of giving instructions by telephone/ emails/ any other communication. It should be noted that if regular instructions are given from India, PoEM may be considered to be in India.
- It may be pertinent to note that it is not difficult for the Income Tax department to procure detailed records of phone calls, emails, and other forms of electronic communication.

## **Section C – Day to Day operational services/ functions**

Foreign Entity should ensure that key management and commercial decisions should not be taken in India. However, day to day routine operational functions (like payroll functions, accounting functions, IT infrastructure functions, Human Resource, etc.) undertaken by junior and middle management are not relevant for the purpose of determination of PoEM. Company can outsource such functions to a third party or related party on a chargeable basis (if outsourced to a related party, the charge should be at arm's).



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