



Final guidelines issued for determination of Place of Effective Management of companies

Guiding Principles

The Central Board of Direct Taxes (CBDT) today issued final Guiding Principles for determination of the Place of Effective Management (POEM) of companies (hereinafter referred to as 'Final Guidelines'). These follow the draft Guiding Principles that had been released by CBDT on 23 December 2015 for public comments.

The key highlights are set out below (additions made in the Final Guidelines are shown in *italics*).

'Active Business outside India' test

It is proposed that the process of determination of POEM will primarily be based on whether the company is engaged in 'active business outside India'. Under the guidelines, a company can be said to be engaged in active business outside India if the following cumulative conditions are satisfied:

- Its passive income (income by way of royalty, dividend, capital gains, interest, rent and income from both the purchase and sale of goods from/to associated enterprises) is not more than 50% of its total income;
- Less than 50% of its total assets are situated in India;
- Less than 50% of its total number of employees are situated in India or are resident in India; and
- Payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Under the Final Guidelines, an explanation has been added defining the terms, 'income', 'value of assets', 'number of employees' and 'pay roll'.

The term 'income' has been defined as income 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 the average of value for tax purposes in the country of incorporation of the company at the beginning and at the end of the previous year both in case of individually depreciable assets and pool of fixed assets treated as a block for depreciation. For any other assets, the value as per the books of accounts is to be taken.

The term 'number of employees' has been defined as the average number of employees as at the beginning and at the end of the year. It is also provided that 'employees' shall include persons who, though not employed directly by the company, perform tasks similar to those performed by the employees.

The term 'pay roll' has been defined inclusively to include the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.

The Final Guidelines exclude interest income earned by banks and public financial institutions from the scope of passive income.

Guidelines for determining POEM for companies engaged in Active Business outside India

In the case of companies engaged in active business outside India (under the above test), the POEM shall be presumed to be outside India if the majority of the meetings of the Board of Directors of the company are held outside India.

Mindful that the POEM concept is stated to be one of substance over form, it is provided that if the facts and circumstances establish that the Board of Directors are standing aside and not exercising their powers, 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.

Under the Final Guidelines, it has been clarified that merely because the Board of Directors follow global policies relating to pay roll functions, accounting, human resource, IT infrastructure, supply chain, routine banking operations, that are not specific to an entity or group of entities per se, etc., it would not imply that the Board is standing aside.

In making the determination whether the company is engaged in active business outside India the average of the data of the previous year and two preceding years is to be taken into account. If the company has been in existence for a shorter period, data for the shorter period is to be taken. *It has been clarified that where the accounting year for tax purposes in the country of incorporation is different from the previous year (i.e. financial year), then the date of the accounting year that ends during the relevant previous year and two accounting years preceding shall be considered.*

Guidelines for determining POEM for companies that are not engaged in Active Business outside India

The Guiding Principles envisage a two-stage process for determination of POEM for companies that are not engaged in an active business outside India:

- Stage 1 involves the identification of the persons who actually make the key management and commercial decisions for the conduct of the company's business as a whole;
- Stage 2 involves determination of the place where the decisions are in fact being made.

The proposed principles for determining the POEM in such situations are as under:



Decisions v. Implementation

The place where management decisions are taken will be more important than the place where the decisions are implemented.

Location of Board of Directors

The location where the Board of Directors regularly meets may be the POEM provided:

- The Board retains and exercises its authority to govern the company; and
- The Board, does, in substance, makes the key management and commercial decisions necessary for the conduct of the company's business as a whole.

The mere formal holding of the Board Meetings at a place will not by itself be conclusive for determination of POEM. If key decisions by the directors are being taken at any other place, such place would be relevant for determining the POEM.

If the Board has delegated the authority to make key management and commercial decisions to the senior management or any other person *including a shareholder, promoter, strategic/legal/financial advisor, etc.*, and does nothing more than ratify their decisions, the POEM will ordinarily be where such senior managers or other persons make those decisions.

In cases where the Board has (de facto or de jure) delegated some or all of its authority to one or more committees, the location where key members of the committee are based and where the committee develops and formulates key strategies for the formal approval of the Board will be the POEM.

Location of the Head Office

The Guiding Principles provide that the location of the head office will be an important factor in the determination of POEM and provides for parameters that are relevant in determining the location of a company's head office.

Where the company's senior management and their support staff are based in a single location which is held out as the company's principal place of business or headquarters, such place will be the place where the head office is located.

Where a company is decentralised, the head office will be where the senior management:

- Are primarily or predominantly based; or
- Normally returns, following travel to other locations; or
- Meet when formulating or deciding key strategies and policies for the company as a whole.

Where members of senior management operate from different locations and participate in meetings via telephone or video conferencing, the head office will be the place where the highest level of management and their direct support staff are based.

However, it is provided that where it is not possible to determine the company's head office with a reasonable degree of certainty, the location of the head office will not be of much relevance in determining POEM.

The Final Guidelines also provide guidance for determining POEM where resolutions are passed by way of circular resolutions or through round robin voting. In such cases, 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 the decisions would be important.

The Final Guidelines also clarify that a mere exercise of shareholder powers on matters reserved for shareholder decisions (such as those including sale of substantial/all assets of the company, dissolution, liquidation) under applicable company law are not relevant for determining the POEM of a company since they do not affect the conduct of the company's business from a management/commercial perspective.

However, it has been specified that in some cases, a shareholder's involvement can result in effective management by shareholders' agreements or through actual conduct (for instance where the shareholders limit the authority of Board/senior managers).

Other factors

It is clarified that routine operational decisions taken by junior and middle management will not be relevant for the purpose of determining POEM. *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 the key management decisions are concerned with broader strategic and policy decisions.*

Where the factors referred to above do not lead to a clear identification of POEM, then the following secondary factors are provided for consideration:

- Place where the main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

Factors that are not determinative of POEM

It is sought to be emphasised in the draft that POEM is not to be determined on the basis of isolated facts that by itself do not establish effective management. Some illustrative factors that will not be conclusive evidence that the conditions for establishing POEM in India are satisfied are provided. These are:

- The fact that a foreign company is wholly owned by an Indian company
- *The fact that there exists a Permanent Establishment of a foreign entity in India*
- The fact that one or some of the directors of a foreign company reside in India
- The fact that local management is situated in India in respect of activities carried out by a foreign company in India
- The existence in India of support functions that are preparatory and auxiliary in character

The guidelines note that the principles set out therein are for guidance only and that no single principle will be decisive in itself. It is also stated that the principles are to be applied with reference to activities performed over a period of time during a previous year, and not by means of a 'snapshot' approach.

Procedural aspects and Safeguards

From an administrative standpoint, it is stated the Assessing Officer (AO) before initiating any proceedings for holding a company incorporated outside India as a resident of India based on POEM has to seek prior approval of the Principal Commissioner/ Commissioner.

Further, the Final Guidelines also provide that if an AO proposes to hold a company incorporated outside India, as being resident in India, on the basis of its POEM, then any such finding shall be given by the AO after seeking prior approval of a collegium of three members



(consisting of Principal Commissioners or Commissioners). The collegium so constituted shall provide an opportunity of being heard to the company before issuing directions.

Illustrations

The Final Guidelines also carry certain illustrations to provide guidance on the practical application of the principles of POEM. For instance, in a situation where the foreign company's majority board meetings are held outside India, then the POEM shall be presumed to be outside India (assuming other factors demonstrating that the foreign company carries on active business outside India are met).

Similarly, where powers to approve most contracts are required to be approved by shareholders (i.e. Indian residents), it may indicate that the effective management of the company has been usurped by the parent company, and hence POEM may not be presumed to be outside India even if the company is engaged in active business outside India and majority of its board meetings are held outside India.

Monetary Threshold

It has been clarified in the Press Release issued by the CBDT that the POEM guidelines shall not apply to companies having turnover or gross receipts of INR 500 million or less in a financial year.

Our Comments

The Final Guidelines incorporate several recommendations made by taxpayers, and provide increased clarity on how POEM Rules will be applied. However, as is stated in the Guidelines themselves, the determination of POEM will be fact based. Hence, an element of subjectivity in its application is perhaps inevitable. Still, the Final Guidelines should prove to be useful to taxpayers in evaluating their residential status under Indian law.

The Finance Act, 2016 had also introduced section 115JH in the Income-tax Act, 1961 to enable the Government to notify rules in relation to computation of income, carry forward and set-off of losses, treatment of unabsorbed depreciation and applicability of transfer pricing in relation to foreign companies which are treated as being resident in India. Rules in this regard are still awaited.



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