

INDIA – GUIDELINES ISSUED FOR DETERMINING PLACE OF EFFECTIVE MANAGEMENT

Authors

Ashutosh Dixit
Parul Jain
Kaushik Saranjame

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Ashutosh Dikshit is Of Counsel, Parul Jain is a Partner, and Kaushik Saranjame is a Director in the Corporate Tax Practice of BMR & Associates LLP, where they advise a number of Fortune 500 multinationals and private equity and venture capital firms with respect to investments in India.

BACKGROUND

Under the Income Tax Act, 1961 (“the Act”), the tax residence of a corporation formed outside of India was determined based on whether the control or management of its affairs was wholly situated in India. On the other hand, most of India’s tax treaties determined the tax residence of a foreign corporation using the place of effective management (“P.O.E.M.”) principle.

The P.O.E.M. principle for determining the tax residence of a foreign corporation was introduced into the domestic law by amending §6(3) of the Act, and is effective from F.Y. 2016-17. In December 2015, the Central Board of Direct Taxes (“C.B.D.T.”) released draft guidelines laying down principles to apply when determining the P.O.E.M. of a foreign corporation.¹ Now, the C.B.D.T. has issued final guidelines in the form of Circular No. 6/2017 (the “Circular”), dated January 24, 2017.

PRESS RELEASE

According to the press release issued with the Circular, the intention of the final guidelines is not to target Indian multinational groups engaged in business activities outside India. Rather, the target is shell corporations and corporations used for retaining income outside India where the real control and management of affairs is in India.

In addition, the guidelines are not intended to cover foreign corporations or to tax their global income merely because a permanent establishment (“P.E.”) or a business connection exists in India. The P.O.E.M. provisions do not apply to foreign corporations with a turnover or gross receipts of less than INR 500 million (U.S. \$7,424,132 converted at an exchange rate of U.S. \$1 = INR 67.3479) in a financial year, although this was not stated in the Circular or in the Act.

EXISTENCE OF AN ACTIVE BUSINESS OUTSIDE INDIA

Like the draft guidelines, the final guidelines provide that for testing the applicability of P.O.E.M. provisions the first step is to determine whether the foreign corporation is engaged in “active business outside India.”

A foreign corporation is engaged in active business outside India if it meets the following criteria:

¹ Regarding these draft guidelines, see [“CBDT Issues Draft Guiding Principles for Determination of Place of Effective Management,”](#) Tax Edge 12.3 (2015).

- Its “passive income”² is not more than 50% of its total income.
- Less than 50% of its total assets and employees are situated and resident in India.
- Its payroll expenditure related to employees in India is less than 50% of its total payroll expenditure.

The final guidelines establish the method for computing the percentages used in each of the three factors listed above. Data for each factor listed above – (i) income, (ii) assets and employee headcount, and (iii) payroll expenses – is gathered for the fiscal year in issue and the preceding two fiscal years. The data is gathered first by looking at India alone and then on a global basis (*viz.*, India and the rest of the world). For each factor, the average of the Indian data is divided by the average of the global data and the relevant percentage is computed for each factor. If the Indian fiscal year differs from the tax year used by the foreign corporation, the data for the foreign corporation’s tax year ending within the relevant Indian fiscal year is used.

The final guidelines further provide that interest income is not considered passive income for a foreign corporation that is engaged in the business of banking or is a public financial institution and whose activities are regulated under the applicable laws of the country of incorporation.

FUNCTIONS OF THE BOARD OF THE FOREIGN CORPORATION

The final guidelines provide that the P.O.E.M. of a foreign corporation that is engaged in an active business outside India will be considered to be outside India if the majority of its board meetings are also held outside India, provided that no person resident in India actually exercises the powers of management over the foreign corporation.

If the board of the foreign corporation merely follows the Indian group’s policies in functional areas such as accounting, payroll, and human resources, the board will be regarded as not exercising its powers of management over the foreign corporation. This rule is subject to the following clarifications:

- Where board resolutions are passed through written consent of the board members instead of board meetings, the mere location of the proposer of a resolution is not determinative of the place of management. Other aspects, such as the frequency of use of this mode of decision making, the type of decisions being made, and the other parties involved, will be considered in order to determine the actual person who has the authority to make a decision.
- Shareholder activities in terms of making decisions on matters that fall within their domain as shareholders under corporation laws (*viz.*, approving mergers or acquisitions) are not relevant to the determination of the P.O.E.M. of the foreign corporation. However, where the shareholders, and not the board, are the persons who are exercising the real authority over the affairs

² Passive income will include, *inter alia*, interest income and income from the purchase and sale of goods from associated enterprises.

of the foreign corporation, then this will be relevant for the determination of the P.O.E.M. of the foreign corporation.

PROCEDURAL ASPECTS

While the draft guidelines provided that a tax officer must obtain prior approval of the Commissioner before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, the final guidelines now provide a two-tier procedure:

- The tax officer must obtain prior approval of the Commissioner before initiating any inquiry into the tax residence of a foreign corporation under the P.O.E.M. provisions.
- The tax officer must further obtain prior approval of a panel of three Commissioners before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, and as a part of the process, the panel must provide an opportunity to the foreign corporation to make submissions in the matter before issuing its directions to the tax officer.

OTHER ASPECTS

It has also been clarified that the presence of a P.E. in India on behalf of a foreign corporation does not constitute conclusive evidence that its P.O.E.M. is in India.

The final guidelines also provide certain illustrations explaining the manner of application of the guidelines, for example:

- Even where the foreign corporation meets the “active business outside India test” and the majority of its board meetings are conducted outside India, it can be regarded as a tax resident of India under the P.O.E.M. provisions if it is established that the foreign corporation seeks permission from its Indian parent with respect to virtually all business transactions.
- In a two-tier holding structure where the top tier entity is regarded as a tax resident of India under the P.O.E.M. provisions, the tax residency of the downstream entities must be separately evaluated under the P.O.E.M. provisions.

COMMENTS

The P.O.E.M. provisions could have been withdrawn and replaced by a controlled foreign corporation (“C.F.C.”) provision that eliminates deferral immediately in certain circumstances, but the Indian government has refrained from adopting that approach. Instead, it adopted final P.O.E.M. guidelines with certain safeguards, clarifications, and illustrations. Notably, the safeguards now provided should give taxpayers comfort against the indiscriminate use of P.O.E.M. provisions.

Indian multinational groups with captive subsidiaries that undertake purchases and sales with group corporations may need to revisit their structures and decision-making processes, as they may not pass the active business outside India test under the P.O.E.M. guidelines.

Given that the P.O.E.M. provisions have already come into effect as of the beginning



of the current F.Y. 2016-17, the final guidelines may lead to hardship because of their retroactive effect. The Indian government has been urged to consider deferring the effective date of the P.O.E.M. provisions to F.Y. 2017-18. Additionally, various other aspects related to the computation of income of foreign corporations having a P.O.E.M. in India (e.g., tax rate applicable, tax credit mechanism, etc.) are yet to be clarified.

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