



## CBDT issues guiding principles for determination of the Place of Effective Management of a company

Prior to the amendment to Section 6(3) of the Income-tax Act, 1961<sup>1</sup> (the Act), 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. The provisions of Section 6(3) of the Act were amended<sup>1</sup> with effect from 1 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 (POEM) in that year is in India. These provision have come into effect from 1 April 2017 and it applies from Assessment Year (AY) 2017-18 onwards.

On 23 December 2015, the Central Board of Direct Taxes<sup>2</sup> (CBDT) issued draft guiding principles for the determination of POEM of a company. Comments/suggestions on this draft guidance were invited from the stakeholders as well as the general public.

Today, the CBDT<sup>3</sup> has issued the guiding principles to be followed for determination of POEM. Key changes to the guiding principles are summarised as follows:

### **Active business outside India**

A company shall be said to be engaged in 'active

business outside India' if the passive income<sup>4</sup> is not more than 50 per cent of its total income; and

- less than 50 per cent of its total assets are situated in India; and
- less than 50 per cent of total number of employees are situated in India or are resident in India; and
- the payroll expenses incurred on such employees is less than 50 per cent of its total payroll expenditure.

Additional explanation has been inserted in the final guidelines which is as follows:

For the aforesaid purpose -

- The income shall be –
  - as computed for tax purpose in accordance with the laws of the country of incorporation; or
  - as per books of account, where the laws of the country of incorporation does not require such a computation.

<sup>4</sup> '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. This exception was not there in the draft guidelines.

<sup>1</sup> By Finance Act, 2015.

<sup>2</sup> F. No. 142/11/2015-TPL

<sup>3</sup> CBDT Circular No. 06/2017, dated 24 January 2017

- The value of assets –
  - 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
  - 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;
  - In case of any other asset, shall be its value as per books of account;
- 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;
- 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.

Any determination of POEM will depend upon the facts and circumstances of a given case. The concept of POEM 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 POEM at any point of time. Since 'residence' is to be determined for each year, POEM will also be required to be determined on a year on 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.

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

However, if on the basis of facts and circumstances it is established that the board of directors (BoD) 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 POEM shall be considered to be in India. In addition to draft guidelines, it is provided that merely because the BoD follow general and objective principles of global policy of the group laid down by the parent entity which may be in the field of payroll 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 would not constitute a case of BoD of companies standing aside.

Further for determining whether the company is engaged in active business outside India, 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. In addition to draft guidelines, where the accounting year for tax purposes, in accordance with laws of the 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.

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

- 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.
- Second stage would be determination of place where these decisions are in fact being made.

### **Location criteria**

The place where 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.

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

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

- 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 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 the head office<sup>5</sup> of the company is located or such location is unconnected with the place where the predominant activity of the company is being carried out.

### **Delegation of authority**

- 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 POEM will ordinarily be the place where these senior managers or the other person make those decisions.
- 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 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).

### **Location of the head office**

The location of a company's head office will be a very important factor in the determination of the company's POEM 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 the head office is located.
- If the company is more decentralised (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 –
  - are primarily or predominantly based; or
  - normally return to following travel to other locations; or
  - 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 POEM.

### **Modern technology impact on POEM**

The use of modern technology impacts the POEM in many ways. It is no longer necessary for the persons taking decisions 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.

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<sup>5</sup> '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

## Other guiding principles

- 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 the proposer of the 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. This principle was not there in the draft guidelines.
- The decisions made by shareholders on matters which are reserved for shareholder decisions under the company laws are not relevant for determination of a company's POEM. 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. 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 decisions 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 a case-to-case basis only. This principle was not there in the draft guidelines.
- Day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM. Additionally, the final guidelines provide that 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 decisions 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 the person responsible for operational decisions 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.

- If the above factors do not lead to clear identification of POEM then the following secondary factors can be considered :-
  - Place where main and substantial activity of the company is carried out; or
  - Place where the accounting records of the company are kept.
- It needs to be emphasised 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:
  - 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.
  - The fact that there exists a Permanent Establishment (PE) of a foreign entity in India would itself not be conclusive evidence that the conditions for establishing a POEM in India have been satisfied. This principle was not there in the draft guidelines.
  - 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.

- 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.
- 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.
- Above principles for determining 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 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
- 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.
- Additionally, the final guidelines provide that 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.
- The illustrations to highlight applicability of certain principles are summarised in the Annexure 1.

## Our comments

The final POEM guiding principles are similar to the draft with an attempt to provide contextual clarity on several open issues. The final guidelines provide guidance on 'income', 'value of assets', 'number of employees' and 'payroll' in context of determining 'active business outside India' which were not present in the draft.

The guidelines are primarily based on the fact as to whether or not the company is engaged in 'active business outside India'. For determination of 'active business outside India' factors such as passive income, total asset base, the number of employees, payroll expenses in India and outside, etc. are considered. The guidelines state that the concept of POEM is one of substance over form. It also deals with the impact of modern technology in POEM determination. These guidelines are not intended to cover foreign companies or to tax their global income, merely on the ground of presence of PE, a foreign company completely owned by an Indian company, some of the directors are resident in India, etc. An important exception has been provided for 'interest' income earned by a banking companies/Public Financial Institutions (PFIs). Any income by way of interest earned by banks/PFIs shall not be considered as passive income. The guidelines provide certain illustrations to provide clarity on various aspects.

The guidelines provide that the AO would require to seek prior approval of the Principal Commissioner or the Commissioner before initiating any proceedings. The AO shall also obtain approval from Collegium of Principal Commissioners of Income-tax before holding that POEM of a non-resident company is in India. It has been clarified that the principles for determining the POEM are for guidance only and a 'snapshot' approach is not to be adopted. This development is expected to have a far reaching impact on taxpayers.

The guidelines attempt to differentiate between shareholder control, management control and routine decisions. Whilst the guidelines are wide-ranging, it is subjective on substance and can be challenged for interpretation in many places. Further, another issue to be considered is how one would comply with these guidelines which are issued only now especially since POEM is effective from 1 April 2016 (AY 2017-18) and we are already ten months down the line. This certainly merits deferment of POEM by a year to 1 April 2017 (AY 2018-19) else this retrospective application could lead to confusion.

## Annexure 1

Sr. No.	Example	Interpretation
1.	<p>Company A Co. is a sourcing entity, for an Indian multinational group, incorporated in country X and is 100 per cent 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 -</p> <ul style="list-style-type: none"> <li>• 30 per cent of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises;</li> <li>• 30 per cent of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises;</li> <li>• 30 per cent of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises; and</li> <li>• 10 per cent of the income is by way of interest.</li> </ul>	<p>In this case passive income is 40 per cent of the total income of the company. The passive income consists of,</p> <ul style="list-style-type: none"> <li>• 30 per cent income from the transaction where both purchase and sale is from/to associated enterprises; and</li> <li>• 10 per cent income from interest.</li> </ul> <p>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.</p>
2.	<p>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 INR5 crore. The annual payroll expenditure in respect of MD, CEO and sales head is of INR3 crore.</p>	<p>Although the first limb of active business test is satisfied by A Co. as only 40 per cent of its total income is passive in nature. Further, more than 50 per cent 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 per cent of the total payroll expenditure. Therefore, A Co. is not engaged in active business outside India.</p>
3	<p>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.</p>	<p>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.</p>
4.	<p>The facts are same as in Example 3 but it is established by the AO 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</p>	<p>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</p>

	previous year more than 99 per cent 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.	are held outside India.
<b>5.</b>	An Indian multinational group has a local holding company A Co. in country X. The A Co. also has 100 per cent 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 POEM 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.	Merely because the POEM of an intermediate holding company is in India, the POEM of its subsidiaries shall not be taken to be 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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