

Indian POEM: A melodious reading?

Tirthesh Bagadiya of Bagadiya & Jain Chartered Accountants analyses proposed place of effective management (POEM) provisions contained in Finance Minister Arun Jaitley's February 28 Budget speech, outlining the main concerns held by businesses.

The India Budget 2015 proposed a number of amendments to the existing law as far as international taxation is concerned. The Union Budget 2015 proposes to amend the Indian tax laws (ITL) to: provide clarity on the taxation of indirect transfer of Indian assets; defer implementation of general anti-avoidance rules (GAAR) by two years; reduce withholding rates for payment of royalties and fees for technical services (FTS); provide clarity on taxation of interest paid by a branch of a foreign bank in India to its head office; enable provisions to frame foreign tax credit rules; clarify the taxation of offshore funds which have fund managers based in India; and outline reporting requirements for foreign payments, among others. All these proposals are welcomed by the international community and are in line with the government's assurance of a non-adversarial and certain tax regime. However, one proposal which is viewed as counter to the government's assurance is the introduction of the place of effective management (POEM) concept as a test for determining corporate residency.

POEM as proposed

Under the provisions of the Income Tax Act, 1961 (IT Act) a foreign company is deemed to be a tax resident of India in a given year if during that year, the control and management of its affairs is situated 'wholly' in India. The Bill proposes to amend the IT Act by providing that a foreign company will be a tax resident of India in a given year if its 'place of effective management' (POEM), at any time in that year, is in India. The Bill proposes to define POEM as "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".

Intent behind the proposed amendment

As per the existing law, a foreign company can be considered as a tax resident of India; and thus be exposed to Indian taxation of its global income, if the control and management of its affairs is situated wholly in India during any financial year. The Parliament



Finding rhythm, melody and harmony with India's POEM provisions

records, in the Memorandum to the Finance Bill, that such lenient provisions around tax residency have enticed many foreign companies to escape the taxation of their global incomes in India, by merely ensuring that at least some management decisions were taken outside India during any previous year, say through convening of a single board meeting outside India, when, in substance, all their key managerial functions were carried out from India throughout the fiscal year.

With a view to plug the loophole or mischief, the Parliament has sought to introduce the concept of POEM to determine the tax residency of foreign companies in India. The concept of POEM is not new in the global scenario; and also well accepted by the OECD in its model convention for tax treaties. The manner, in which POEM has been defined in the Finance Bill, is also in line with the understanding of the OECD, namely “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”.

Concerns for foreign and Indian multinationals

The point, which raises huge concerns for foreign multinational companies (MNCs), is the manner in which the concept of POEM has been incorporated within the scheme of tax residency, namely that tax residency would be triggered for a foreign company if its POEM is in India at any time during the financial year. The logic which provoked the government to amend the concept of tax residency, namely that an essentially ‘shell’ foreign company could have escaped tax residency by merely convening a single board meeting outside India, might actually negatively impact a foreign MNC, which otherwise has management and control of its affairs outside India, but which might just convene a single board meeting in India and end up being deemed tax resident in India as a result.

Tax consequences under the Income Tax Law

The tax consequences are immense since a resident is liable to tax on the worldwide income while a non-resident is liable to tax only on the income received or sourced in India.

Practically speaking, some of the tax consequences for taxpayers to consider include:

- Past losses assessed in a foreign jurisdiction will be ignored, when total income is computed as a tax resident for the first time (by applying POEM);
- Owing to the absence of taxable income in the foreign jurisdiction on account of past losses, the situation of granting foreign tax credit will not even be visited, which means India will tax profits without granting set-off of past losses; and
- Local incentives secured by an overseas subsidiary will have to be effectively forfeited when India taxes such subsidiary as a resident in India.

Tax treaty consequences

POEM may also lead to situations of dual residency. Provisions contained in double taxation avoidance agreements (DTAs) operate only when a single resident state is determined. For example, owing to the peculiarities in the India-US DTA, in a situation of dual residency, the beneficial provisions of the DTA cannot be applied. The US, on its part, applies incorporation as the sole test

of residency for companies. It is well known that since the US is a significant market for export of goods and services, many Indian companies have established subsidiaries in the US to address the market demand. POEM provisions proposed in the domestic law could make the DTA inoperative and vitiate the basis on which market access has been secured.

Government safeguards expected

The requirement of the POEM being in India at any time during the year defeats the very essence of the concept of POEM, since the POEM ought to be judged over a reasonable length of time. Over

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the period of a few months or a year one can ascertain where and by whom decisions are made, where decisions are made in various locations, where and who makes the more important decisions, where and who implements the decisions, and so on. In other words, the POEM is supposed to be determined after an evaluation of the affairs of the company throughout the year, not based on any one point during the year.

It is highly desirable that the government provides enough safeguards to ensure that MNCs are not dragged into this net where there is no real intention to manage them from India; some occasional decision-making events happening in India may rather be ignored to determine the place where decision-making ‘in substance’ takes place for the business as a whole. One hopes that the government will take note of the concerns surrounding this amendment and ensure that appropriate changes are made before the Bill is passed and should also lay down clear guidelines collectively with the industry and the CBDT [Central Board of Direct Taxes] members so as to address the practical issues. The guidelines should be in line with principles laid down by the OECD and should specify the following:

- It should not apply to companies not registered in India unless the foreign company operates in India and all decisions connected with foreign companies in substance are made in India;
- It should clarify that the mere presence of a director in India or participation in a board meeting by a director through video conference or phone call would not make the foreign company resident in India;
- It should apply to Indian companies and the key decisions should be beyond normal decisions;
- The guidelines should specify both the positive test and negative test in determining POEM. The positive test must lead to outlining what does not constitute POEM and the negative test should show factors that will determine POEM; and
- Mere advisory role should not be considered as place of making decisions.