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## India Should Rework its Guidance on Place of Effective Management

Shilpa Goel (Tax Lawyer) · Wednesday, January 27th, 2016

The Indian Ministry of Finance released last month draft guidance on applying the “place of effective management” (POEM) test to determine tax residence of companies. The guidance came almost eight months after the Government substituted, through the 2015 Finance Act, the existing “control and management” test with the universal concept of POEM in Section 6(3) of the Income Tax Act, which deals with residence of companies.

The amended Section 6(3) is accompanied by an Explanation which defines 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.” Readers may be aware that this definition is in line with the Organisation for Economic Co-operation and Development’s (OECD’s) definition provided under Article 4(3) of the OECD Commentary (also called the “tie-breaker” rule).

The Explanatory Memorandum released alongside the 2015 Finance Bill promised a set of guiding principles to assist taxpayers and tax officers understand the application and interpretation of this important change. Unfortunately, the guidance is a failed attempt at meeting the expectations that the Finance Ministry had then set for the business community.

To begin with, the guidance states that “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.” Under the guidance, a company is said to be engaged in “active business” in India if, among other things, more than 50 percent of its assets and employees are situated in India. The use of “active business” test to determine POEM is misplaced, especially when the guidance itself owns up that POEM in case of a company engaged in active business outside India shall be presumed to be outside India if the majority meetings of the board of directors of the company are held outside India.

A bare reading of the OECD’s Commentary on Article 4(3) will reveal that the concept of POEM rests not on the place where a company carries on business activities, but on the place where it takes key management and commercial decisions necessary for the conduct of its business. The definition of POEM in section 6(3) of the IT Act (which mirrors the OECD’s definition) requires identifying: (a) what key management and commercial decisions are; (b) whether such decisions are necessary for the conduct of the business; and (c) the place where such decisions are in substance taken. Instead of elaborating further on this, the guidance walks on a different direction

in what could be said to be an attempt to bring more companies into the Indian tax net.

It is unfortunate that the guidance comes up with a new, dominant “active business” test to determine a company’s POEM. If we were to follow international standards, which we ought to, a company’s place of business, let alone its place of active business, cannot be a decisive factor in determining POEM; instead the place of top-level, positive realistic management must always be the company’s POEM (or, as many would point out, the place where the “shots are called”). That the place where a company’s head office is situated cannot be its POEM, unless key management and commercial decisions are taken from that place, reflects this thinking.

The shift from “effective management” to “active management” will place additional burden on companies with transnational operations as they will henceforth be required to prepare and maintain additional documentation to support their position, leading to increased compliance costs. The guidance is also a recipe for increased tax disputes and litigation, which runs contrary to what the Government has continually aspired for, that is, a certain and non-adversarial tax system. In drafting the guidance, the Government should have extensively researched on how countries across the world are interpreting the concept of POEM. Perhaps, POEM guidance released recently by South African Revenue Service (SARS) could have been an excellent starting point, given that the SARS guidance is not only authoritative as it relies on key judicial precedents on the subject but is also illustrative in nature as it provides real-life examples and situations to add some perspective.

Having said that, the guidance does borrow key principles from the OECD Commentary on Article 4(3), including the principle that the place where decisions are taken shall be more important than the place where decisions are merely rubber stamped. The guidance also rightly states that in situations where a company’s Board delegates authority (either *de facto* or *de jure*) to the executive committee, the company’s POEM shall be place where the committee is so based. However, the guidance fails to clearly illustrate the nature of decisions that shall be taken into account in determining POEM (operational decision-making as opposed to managerial decisions).

It is but essential that the revised guidance elaborate upon “key commercial and managerial decisions” and distinguish it from day-to-day operational decision-making. The revised guidance must clarify vague phrases such as: “POEM shall be presumed to be in India if it has been predominantly in India during any previous year POEM is both within and outside India.” The revised guidance must also clarify as to how POEM can be said to be “predominantly” in India given that the guidance itself states that a company can have only one POEM. The principle that the existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence of POEM also needs further clarification.

Last, given the importance of residence in determining tax liability, it is imperative that the revised guidance explicitly specify the date on which the new rules shall take effect. POEM is to be determined based on the activities performed over a period of time in the financial year and, therefore, the changes should be applied in the following financial year to ensure certainty and to reduce avoidable litigation.

In its current form, the guidance raises more questions than it answers. It is likely that foreign tax jurisdictions will not accept India’s “active business” test, which will further delay MAP proceedings. This is a definite cause for concern as the OECD in Action Item 6 (treaty abuse) of its base erosion and profit shifting (BEPS) project (in which India is taking part as an “Associate”) has recommended countries to settle dual-residence conflicts through MAP. It is in India’s own interest

to abandon “active business” test and bring its rules on residence into line with the OECD’s Commentary on Article 4(3). In any event, the revised guidance must, if it chooses to retain the “active business” test, set out additional clarifications to help companies navigate through this important change.

**All views are personal.**

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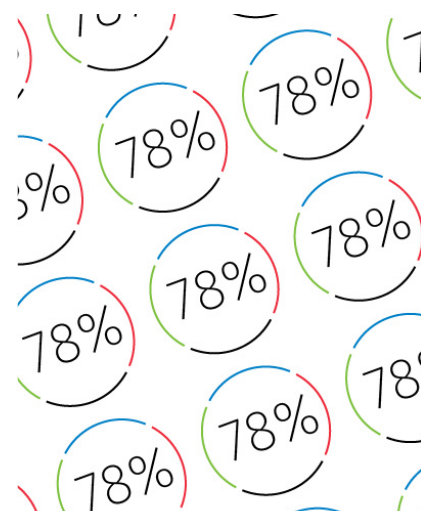
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