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Place of Effective Management: Indian Perspective

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India introduced the place of effective management (POEM) in its domestic law in Finance Bill of 2015 but due to lack of preparedness it was deferred to April 1, 2017 and made applicable from assessment year 2017-2018. The statement of intent revealed that the purpose of its introduction was to determine the residential status of companies and serve as an anti-avoidance measure. (see Explanatory Notes to the Provisions of the Finance Act, 2015).

To give effect to POEM, Section 6(3) of Income-tax Act, 1961 was amended. Prior to the POEM test, a company was considered resident if its control and management was "wholly situated in India". An absolute threshold meant that companies could avoid being classified as a resident by merely holding at least one key board meeting outside India (see Radha Rani Holdings (P) Ltd. vs Additional Director of Income Tax). This ostensible loophole warranted a change in the test for determining residential status which paved way for the adoption of the POEM test supported with Rules.

Another justification given by the Finance Act was that the move will align Indian domestic law with its tax treaties. What is the Indian understanding of POEM? What could possibly be achieved by such alignment?

OECD has moved away from POEM to a case-by-case resolution using mutual agreement procedure (MAP) for determining conflicts of dual residency (see 2017 Update to OECD Model Tax Convention). The Multilateral Instrument (MLI), signed in June 2017, mirrors this approach and India has signified its consent to the same (see India's MLI positions). Does this mean that the attempt at the aforementioned alignment is in vain?

This blogpost attempts to answer the aforementioned questions.

Place of Effective Management under the Income-tax Act, 1961

POEM is defined as the place where the "key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made." A circular issued by the tax department introduces a series of new sub-test to address unintended consequences of POEM, based on whether a company has active business outside India (see Circular 6/2017 of the Central Board of Direct Taxes).

A company is considered to have active business outside India when (a) its passive income (understood as an aggregation of sale and purchase transactions between related parties, royalty, interest, dividend, capital gains) is less than 50% of its total income; and (b) the number of employees in India, value of assets in India and payroll expenses relating to Indian employees is less than fifty percent of the company's total employees, assets and payroll expenses, respectively. The determination of these factors is based on an average of the data pertaining to the relevant financial year and two previous years. A company having an active business outside India is presumed to be non-resident as long as majority of its board meetings are held abroad. For all other companies, the investigation of residence would involve identification of (a) persons who are responsible for management decisions and (b) place where decisions are actually made.

The circular enumerates various factors and situations but signs off saying that the principles are only for *guidance*, leaving the entire law and circular subjected to varying interpretation. Where all factors are inconclusive, place of main and substantial activity and place where accounting records are maintained can be considered. This is one of the instances where factors are mentioned without reference to an internal hierarchy. If POEM is found to be in more than one country, it would be considered to be in India if it is mainly / predominantly in India. This leads to uncertainty for taxpayers and potentially more claims of dual residency under India's tax treaties. Finally, if POEM is in 2 jurisdictions, India would assume that POEM is located in India, including with treaty Partners, thereby disregarding the treaty provisions.

Companies having turnover or gross receipts less than INR 500 million will not come under the scrutiny of POEM (see Circular 8/2017 of the Central Board of Direct Taxes). Foreign companies considered residents upon application of the POEM test will have to pay a 40% tax (as opposed to domestic companies) on its worldwide income to the Indian authorities (see Notification 29/2018 of the Central Board of Direct Taxes, dated June 22, 2018).

Aligning Domestic Law with Tax Treaties

The extensive circular makes contradictory statements on whether POEM can exist in more than one country. It is anomalous for domestic law to state that POEM cannot be in more than one jurisdiction as if it were the case, there would be no need for a tie-breaker rule. Supplanting language from treaty context in the domestic law must be done with caution.

Indian tax treaties, just like the OECD and UN Model Conventions, do not define the POEM tie-breaker rule. Article 3(2) of tax treaties allows Contracting States to import the domestic law meaning of terms not defined within the treaty *unless the context otherwise requires*. Indian tax officials may argue that POEM as a tie-breaker rule must be attributed the same meaning as under the domestic law. Introduction of POEM in the domestic law is perhaps motivated by India's attempt to align the meaning of the tie-breaker with its domestic law definition rather than the other way round.

It would be interesting to see if this argument would be successful given the difference in the intended function of the domestic law test vis-à-vis a tie-breaker rule.

POEM Test in Tax Treaties after the MLI

Article 4 of the MLI recommends use of MAP to resolve any dual residency claims on a case-by-case basis. India has adopted Article 4. This is not a minimum standard and hence, countries may express reservations. However, this does not mean end of the road for POEM.

Firstly, not all Indian tax treaties will be impacted by MLI. For example, India's treaty with Mauritius will not undergo any change as Mauritius has not listed it as a Covered Tax Treaty (see Mauritius' MLI positions). POEM would still remain to be the tie-breaker rule under the treaty. Similarly, some countries such as Singapore have expressed a reservation in respect of Article 4 (see Singapore's MLI positions). In turn, POEM still remains the tie-breaker rule. India's treaties with Mauritius and Singapore are important as most foreign direct investment comes in from these countries.

Secondly, even for treaties covered by the MLI, the case-by-case approach still includes POEM as a criterion that may be considered by competent authorities. Examples of such treaties are India's tax treaties with Australia, United Kingdom and South Africa (see the MLI positions of Australia, the United Kingdom, and South Africa).

While India uses POEM in the domestic law, Australia and United Kingdom use the common law test of control and management.

On the other hand, South Africa poses an interesting situation as it also uses POEM in its domestic law. However, there are differences between the Indian and South African understanding of POEM. For example, the South African interpretation note considers economic nexus irrelevant ordinarily while India looks at the active business outside India test (see Interpretation Note 6/2015).

If India invokes Article 3(2), it is possible that South Africa would follow suit which could lead to a potential deadlock. Hence, one may argue that in the case of a tie-breaker rule, domestic law meanings should not be invoked by Contracting States. Competent authorities may benefit from using an independent criterion for resolving conflict in such instances.

Concluding Thoughts

The wider domestic law test in India points to more instances of dual residency. MLI contemplates that if dual residency claims cannot be settled, taxpayer is not entitled to benefit under treaty except to the extent and in the manner agreed by competent authorities. Hence, any breakdown in the talks between competent authorities could have serious implications for the taxpayer. The dual residency tie-breaker rule not being a minimum standard is failure of the OECD-BEPS inclusiveness since any signatory to the MLI can resort to unilateral steps for denying treaty benefits on the ground that it's the domestic law that sits over the treaty for determining the test of residence. It is important to find alternatives to securing the taxpayer's interest within the given framework of domestic law read with the treaty and MLI provisions.

(**Ashrita conducted research for this piece at the University of New South Wales as part of the Abe Greenbaum Research Fellowship in July 2018.)

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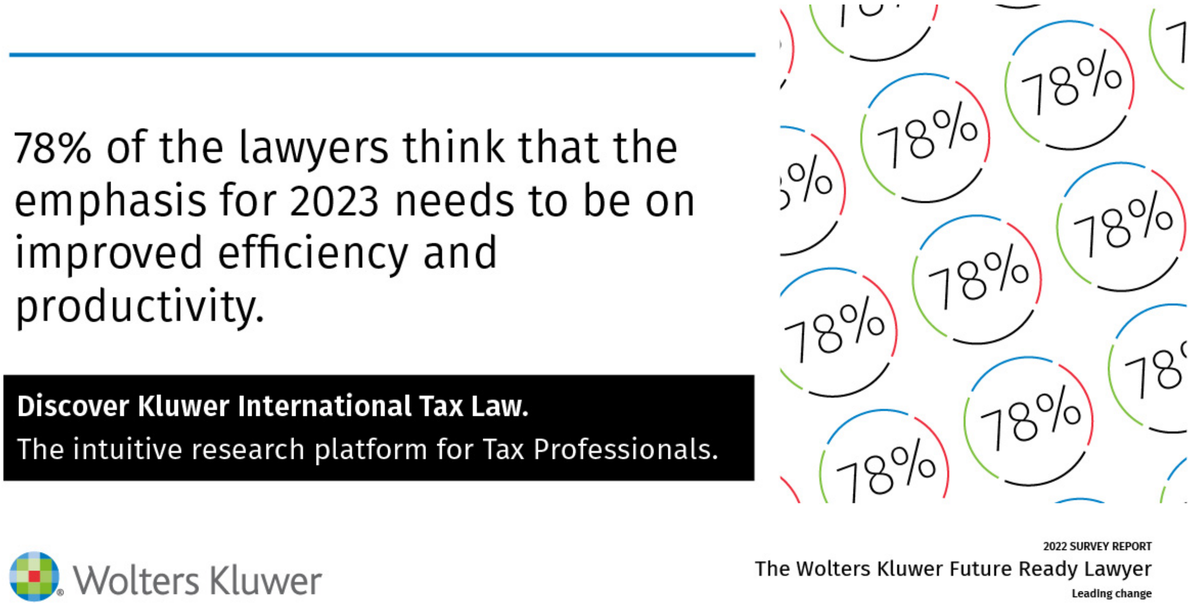

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