

Place of Effective Management (POEM)

- Importance and Precautions

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Short Forms:

BVI	:	British Virgin Island.
CIT	:	Commissioner of Income-Tax.
DTA	:	Double Tax Avoidance Agreement.
DTC	:	Direct Taxes Code.
FEMA	:	Foreign Exchange Management Act.
ISP	:	Internet Service Provider.
ITA	:	Income-tax Act.
Key Management:		See Paragraph 4.2 below.
SPV	:	Special Purpose Vehicles.
TP	:	Transfer Pricing.

Notes:

In this paper, when we refer to "Foreign Companies" or "Non-Resident Companies"; we are essentially referring to companies incorporated outside India whom Indian Government is targeting. It covers primarily, companies managed by Indian residents. Such companies - incorporated outside India are referred to in this article as either "Foreign Company" or "Non-Resident Company" depending upon the reference in the paper. The companies that are owned and managed by non-residents are not discussed in this paper.

Finance Bill has not yet become the Law. When it is passed by both houses of Parliament, signed by President & notified, then it will become the law. Then the Government will come out with relevant rules & a circular explaining the provisions of the Finance Act, 2015. Till then this article should be considered an academic discussion useful for getting prepared.

Place of Effective Management

Foreign Company's Residence.

Executive Summary:

The concept of Place of Effective Management (POEM) is used to determine a foreign Company's Residential Status.

Macro Perspective: Central Government of India has launched two separate attacks:

- (i) Attack on "**Tax Evasion**" (Black Money). We are preparing a separate paper on the subject. And it will be presented on our website.
- (ii) Attack on "**Tax Planning**". This is avoidance of Indian tax which is permitted under the Law. Now the Government is changing the law and extending the net of Indian Income-tax. Concept of POEM is part of the attack on "Tax Planning".

Importance:

If a company's POEM is situated in India; it will be treated as Indian resident. Its global income will be taxable in India. It will have to file its tax returns, audit reports etc. with Indian tax department. If it does not file its income-tax return in India; consequences will be: Its global income will be considered as concealed income. The Company will be considered to be an assessee in default. Hence relevant provisions of the Income-tax Act as well as the Black Money Law - will apply. This is the importance of determining and proving POEM.

Paragraphs 3 to 5 below discuss the concept of POEM. Para 6 discusses consequences. Para 7 to 17 explain steps to be taken to prove non-residential status.

Executive Summary completed.

1. **Residence:**

A Company's Residential Status determines its **global tax liability**. If a company is Resident in India, its global income is taxable in India. If it is non-resident of India, it is liable to tax only on income sourced (earned) in India.

How does one determine tax residential status? Residential status is different under Indian tax law and under Foreign Exchange Management Act (FEMA). Residential status is also different from **citizenship**, domicile, etc. We are focusing purely on residential status under Income-tax.

For an **individual**, the residential status is determined by the physical presence of the individual within India or outside India. For a company, how does one determine whether the company is within India or outside India?

Income-tax department is concerned about foreign companies managed by Indian Residents escaping Indian Income-tax. Hence the department would like to consider such foreign companies as resident in India. Under what circumstances can a foreign company be treated as Indian resident? There are two factors to determine residential status:

(i) **Country of Incorporation.**

Incorporation gives to the company its legal status, legal rights and all regulatory supervision. Normally countries consider place of incorporation as the primary factor to determine residential status. Hence a company incorporated in India is always considered to be Resident in India. Conversely, a company incorporated outside India, is prima facie considered a Non-Resident company.

(ii) **Seat of Management:**

It is normally presumed that the seat of management is in the same country where the company is incorporated. In the modern times, it is easy to have the place of incorporation and place of management in different countries. In fact, many companies plan this.

It is possible that the Country of Ownership (shareholders' normal residence) and Country of Management (place where directors normally function) are in India. But the company is incorporated outside India. This is especially more convenient where the company's business and or investments are outside India.

For Residential status, it is normally considered that - Country of Ownership - shareholders' residence is NOT relevant. Even for directors, their country of residence is not important. Where they actually function,

is more important. When the directors reside in one country and their place of functioning/ management is in another country; it will be for the company to prove its place of management.

2. **Present Position:** Under the Indian Income-tax Act, Section 6 (3) (ii) provides following definition:

*“S.6 (3) (ii) A company is said to be resident in India in any previous year, if..... during that year, the **control and management** of its affairs is situated wholly in India.”*

- 2.1 The implications of this definition are such that even if a foreign company had a small fraction of its management situated outside India, it would not be having “the **whole of its management in India**”. Hence a company could avoid Indian tax by having one director outside India, holding some board meeting outside India etc.

- 2.2 Indians have opened thousands of **Special Purpose Vehicles (SPVs)** for foreign projects/business or investments. These are companies incorporated outside India for a special purpose. 100% of the shares may be held by Indian residents. The Board of Directors may be of Indian residents. Most of the decisions may be taken in India. Yet, such a company would avoid Indian Income-tax on its foreign income and Indian wealth tax on its foreign wealth by keeping a part of its management outside India.

3. **POEM:**

- 3.1 The proposed definition of corporate residence changes the situation. For treating a foreign company as resident in India, from 1st April 2015, it will not be necessary to have the **whole of its Control & Management** to be situated in India. If its **effective management** is situated in India, the foreign company will be treated as Indian resident.

This would mean that thousands of foreign SPVs created by Indians may be treated as Indian Residents.

Under the Finance Bill as presented on 28th February, 2015, the definition included the phrase: “**at any time**”. There was an apprehension that due to this phrase, if the POEM is situated in India even for a day, the company will be treated as Indian Resident. The Finance Minister has removed the phrase at the time of moving the bill in Lok Sabha on 30th April, 2015. This makes it clear that government does not intend to cover occasional/ casual decision taking from India. POEM will be considered to be situated where, the Key Management is exercised in substance.

4 Important Phrases:

4.1 Effective management:

The words Effective Management refer to actual management and not just formal or ostensible management. For example, in some SPVs, the consultants may be the directors. One consultant/ solicitor/ banker may be managing a thousand companies. The clerical staff of this company may be on the board of all the thousand companies. This is management for the sake of name. They cannot be considered as effective directors. To establish effective management, one will have to appoint directors who are competent to take business decisions. Having just one or a minority of professional directors to comply with local regulations would be ok. However, the Key Management should comprise of genuine business managers.

4.2 Key Management:

(i) The term “Key Management” has significance. The definition does **not** use the term “**Board of Directors**”. The Board may meet only once in a few months. Actual management of the company on a regular basis may be conducted by the managing or executive directors and CEO or similar other important executives. Key persons who actually manage the company are to be considered and not the Board of Directors. If the key managerial persons conduct management from a specific place; that will be the POEM of the company.

(ii) A company may have several business functions. It may have a few factories, several shops, different offices for purchase and administration, and one head office where the directors and chief executive officers function. The day-to-day operations and business transactions will take place at all the factories, sales offices and purchase offices. However, those operations are not important while determining the key management. Directors and CEOs take **key managerial decisions**. Hence company’s POEM will be considered where the key managers function. This group is referred to in this article as “Key Management”.

4.3 POEM outside India:

It may be noted that for the purposes of Income-tax Act, Section 6; what is important is determining that the **POEM is not situated in India**. Technically, it is not necessary to prove that the POEM of the company is situated at some specific place outside India. This situation can be compared to: “**Negative Evidence**” & “**Positive Evidence**”. Proving that the POEM does not lie in India – requires Negative Evidence. It may be difficult to prove. However, proving that the POEM lies in a specific country is positive proof and can be established more easily. Hence having the POEM in a specific country is a tremendous help, but not legal necessity.

A company may hold its meetings in different hotels and in fact in different countries. The company will have registered office with some consultant outside India. For the board and shareholders' meetings, it will keep meeting in different countries depending upon its business requirements. Key Management may be spread over a few countries. They may hold meetings by Virtual Conferences. It is not legally necessary that there should be one specified, identified place of management. It should be sufficient that the office is not situated in India. Company has to plan to prove that its POEM is not situated in India. If the company finds that proving this is difficult, it may prove that the POEM is situated outside India.

4.4 Place:

The term Place refers to a geographical location within a specified country or territory. If the Place of Effective Management is in India, the company will be treated as an Indian resident. Once the POEM is not situated in India; outside India it can be anywhere and in any mode. Thus outside India, the office may be a "Virtual Office".

In case of companies having substantial business, the place of management will refer to the place from where the Key Management normally functions. The directors would have their office. This may be the registered office of the company or any other office. The place where the directors actually manage the business will be considered to be the place of management.

The place of management of the company may be different from the **place of residence of the directors and residence of the shareholders**. For example, the directors may be residing in Abu Dhabi. The company may have office in Dubai. In such a case, the place of management for the company will be in Dubai. Within European union and other places where movement of citizens from one country to another country is unrestricted and regularly taking place, this issue becomes important.

The residence of shareholders is normally irrelevant. Shareholder level control is not the management level control of the company. In some cases, if the shareholders actually take even management decisions, then the place of effective management may be affected. Even in this case, if the shareholders travel to the office of the company and take company management decisions in that office, then the shareholders' residence will not be relevant for determining POEM. Illustration: Mr. A and his family hold 100% equity of an SPV incorporated in Singapore. The SPV has its own office and a board of directors situated in Singapore. Mr. A regularly travels to Singapore and attends the board meetings at Singapore. In those board meetings when management decisions are taken, Mr. A participates in the decision making process. He does not take any decisions while he is

present in India. In such a case, the management is situated in Singapore and not in India.

4.5 **Commercial Decisions:**

The company may have a registered office. This office may be doing the secretarial function of complying with the regulations. This is not important for determining POEM. The place where the Key Management takes important commercial decisions is the place where POEM is situated.

4.6 **Conduct of the Business of an entity as a whole:**

In the illustration given above, the factory, the shop, the administrative office - all the offices may be taking commercial and operational decisions. However, each such office will be largely taking decisions restricted to its own area of work. It is only the Key Management that takes decisions for the entity as a whole. And hence it is the office of the Key Management which is relevant in determining POEM.

4.7 **In Substance:**

These words may refer to several factors.

(a) Key Management may be assisted by several managers, accountants and secretaries. They may be even taking certain commercial decisions. However, in substance, the key managerial decisions will be taken by the key management. The location of the office of other managers etc. is not important in determining the POEM.

(b) Some individual/ **occasional decisions** may be taken in India. However, if majority of the decisions are taken abroad; then the decisions are "in substance" taken abroad.

(c) "..... decisions in substance are made" also refers to actual, real decision making. If the decisions are, in substance made by some people in one country; and then formally minuted by the Board of Directors in another country; then the correct criteria is - where the decisions were actually taken.

Conclusion: For determining the POEM, the office where the Key Management actually functions is the most important factor to consider.

4.8 **SPV:**

Many Indian residents have incorporated SPVs outside India. Some of these SPVs may be acting as holding companies to hold the shares of step down subsidiaries or to hold other investments. The SPV may not have full time executive directors/Key Managers. Most of the directors may be having their own separate businesses /activities. Hence this SPV may be operating from the **office of a consultant**. How does one

determine the Place of Effective Management of such an SPV? Prima facie, such a company does not have a regular office from where the directors function. If the company makes a regular practice, so that at least two or three times a year, the Board of Directors meets outside India, then the company can claim that its POEM is situated outside India. .

If the day to day management does not take place; and if only place of meetings are to be considered; we have to consider the place where the **Board of Directors** are meeting. All the directors may be physically outside India when the meeting takes place. Then the meeting may be by Video conferencing or telephone or Skype or any other means of communication.

5. When does the question of proving POEM arise?

(i) Normally, a company incorporated outside India should be treated as a Non-Resident. Company does not have to prove anything.

(ii) When the company itself considers its POEM to be situated in India; it should suo-moto file income-tax return in India and comply with the Income-tax Act.

(iii) When the company genuinely has a foreign office and actually all management happens outside India, it need not do anything under the Indian Income-tax Act. Except that – it may maintain evidence for the office being situated outside India.

(iv) When some management happens in India and some management happens outside India; it will be necessary for the company: **to decide** where its POEM is situated; **and to prove** where its POEM is situated.

6. Consequences:

6.1 When foreign companies are treated as Indian Residents, the consequences will be as under.

(i) All these foreign companies will have to file their regular **income-tax returns** in India. They will have to obtain Indian PAN.

(ii) Their **global incomes will be taxable** in India. The companies have to pay advance tax and self-assessment tax as applicable.

(iii) They will have to maintain regular **books of accounts**, vouchers and documents like any other Indian resident companies. It will be no use to say that in the country of its incorporation, the accounts are not required.

(iv) These companies will have to get their **accounts audited** – statutory Audit, Tax Audit and where applicable – Transfer Pricing Audit. All these reports have to be submitted to Indian CIT. Again, it will not be an excuse to say that in the country of its incorporation, audit is not required.

(v) These companies have to obtain **TAN** and comply with Indian **TDS** requirements.

(vi) Several other anti-avoidance provisions will apply. For example, cash expenses will be disallowed, loans taken or repaid in cash will be considered as taxable income; excessive remuneration to relatives of people substantially interested in the company will be disallowed, Section 2(22) of the ITA – deemed dividend will apply and so on.

6.2 **Dual Residence:**

The country in which they are incorporated will still consider them as residents. Hence they will have **dual residence** – in India and abroad. Resolving the dual residence will be an issue. If there is a **Double Tax Avoidance Agreement (DTA)** with that country, Article 4(3) of the DTA – “Tie-Breaking Provision” will apply. In absence of the DTA, India will apply Indian Tax Law. There can be Double Taxation. Section 91 will apply and appropriate relief may be available.

The SPV may earn income from a third country. For example, Indian investors have incorporated an SPV in Dubai. The Dubai SPV earns income from Britain. For the British income, which DTA will be applicable?

India will apply India- UK DTA.

Having considered the company as Indian resident, the Indian Income-tax department should give a certificate that the company is Indian Resident.

Based on this Indian Tax Residence Certificate, the company should be able to claim the benefit of India – UK DTA before the UK tax authorities.

Since there is no income-tax in Dubai, the company does not have to prove anything in Dubai.

6.3 Let us consider the **Dual Residence** of a foreign company. In the DTA, the “Tie Breaking Provision” – Article 4(3) will provide that the company’s residence will be where its POEM is situated. Now the term POEM is **NOT defined** in the OECD and U.N. Models of DTA. So which definition will apply?

DTA models - Article 3(2) provide that - where any particular term is not defined in the DTA; the definition provided in the domestic tax law of the country applying the DTA - will be applicable. Hence Indian tax law will be applicable.

6.4 **Transfer Pricing:**

6.4.1 International Transfer Pricing Rules do not apply to transactions between Indian residents. Once the SPV is treated as an Indian resident, its transactions with other Indian residents will not be subject to TP rules. However, domestic transfer pricing rules can apply.

6.4.2 The group may have several companies outside India. Some may be SPVs and some may have substantial business abroad. The SPVs may be considered to be Indian residents. The foreign companies having substantial business abroad may be considered non-residents. The transactions between foreign SPVs and foreign substantial companies will be subject to International TP rules.

6.5 This is just a list of some of the difficulties. It is hoped that the Government will make some rules providing relief from unintended consequences.

7. **How to prove that the foreign company is a Non-Resident?**

What should a company management do so that the foreign company is not treated an Indian Resident?

The first action to be taken is to ensure that **in reality**, the foreign company's **management is not situated in India**. This first step is the most important step. The way, Indian tax law is progressing, "facts and substance" will be more important than "form and paper work". In some cases, proving that the POEM is not situated in India may be difficult. But if the company can prove that its POEM is situated outside India, the corollary will be that the POEM is not situated in India in substance.

Our submission is:

- (i) Have actual effective **management** outside India.
- (ii) Have proper **documentary evidence** to establish before the Indian Commissioner of Income-Tax (CIT) that the foreign company's management is actually situated outside India. We are listing below the steps to be taken for both these factors: Paragraphs 8 to 17.

8. **Physical Office:**

As seen earlier in paragraph No. 4.4 above, it is not a legal necessity that the company should have a place of business outside India. However,

where the company decides to prove that it has a place of management outside India; and hence claim that it has no place of business in India; then following issues may be considered.

If the company does have a specific physical office outside India, it may be **owned** by the company **or** may be **rented** by the company. The foreign company need not have a physical office outside India. Some free zones in UAE permit setting up of **virtual office**. Some free zones provide office in a **business center**. That also should be part of the total evidence.

9. Have atleast **two directors** on the Board of Directors who are **non-residents of India**. Practically it will be better if these directors are also residing in the same country, same city where the location of the foreign company's POEM is to be situated. It would be beneficial in terms of actual cost reduction if the directors are also residing in the same place. However, where this is not practical, directors may be resident anywhere in the world but outside India .

For example, an SPV may be incorporated in **British Virgin Island** (BVI). It would be impractical to find directors who are residents in BVI and are actually participating in business management. Hence the management may decide to locate its POEM in Dubai, Singapore, Hong Kong or any other offshore financial centre.

Care may be taken to ensure that the POEM is not in other taxing countries like Britain, USA, etc. Otherwise those countries will claim their rights to tax the company.

10. It is not legally necessary that POEM should be situated in the same place where the company is incorporated.
11. In our view, professional directors like **solicitors, CAs, bankers** or their staff will not qualify as Key, Effective Management. The directors should be genuine businessmen who will actually conduct the business of the SPV.
12. **Board meetings** of the company should generally be held outside India. Note: as seen earlier in paragraphs 4.2 and 4.4, what is more important is – where the Key Management functions. Board meetings and Share Holders' meetings are additional factors of persuasive value.
13. **Shareholders' meetings** should generally be held outside India.
14. **Licence:**
If the foreign company claims a physical POEM outside India, it should actually have a licence/Municipal registration/regulatory

permission to operate in the relevant area where it claims its POEM is situated.

Illustration: A foreign company may be registered in BVI. The management may claim that its head office is situated in a free zone in UAE. However, the management may not take a proper regulatory permission for the specific company to have an office in UAE. This would not be adequate evidence.

15. All the **books of accounts**, voucher files, etc. should be maintained **at the POEM office**. Many jurisdictions like BVI, UAE etc. do not insist upon maintenance of accounts nor audit of books of accounts. This is no argument for the company for not maintaining books of accounts. One should understand that when it is exposed to Indian tax laws, it should maintain records and evidences that are considered adequate under Indian tax law.

The company should maintain proper **Minutes books** for the Board of Directors as well as shareholders. **Company seal** should be maintained at the POEM office. Proper share certificates should be issued by the company. These certificates may be physically kept with the shareholders – who may be in India. However, the **shareholders' register** should be maintained outside India.

And the management should be able to prove that all these documents are actually maintained outside India. A practical way to do this is: Auditor may physically verify these documents and then give a certificate.

16. **Management Information Systems (MIS):**

While the main accounts are maintained outside India and while the management functions outside India, regular management information reports may be sent to the directors in India. It is a good management to have proper MIS.

17. **Telephone Instructions:**

There are people who take such issues casually. While formally, a Board of Directors would be situated outside India, Indian shareholders may be in the habit of giving instructions by telephone or by emails/ by any other communication medium. It should be noted that if regular instructions are given from India, it may be considered that the POEM is situated in India.

How will the Income-tax department know it?

All internet communications are stored by the **Internet Service Provider** (ISP) for ten years. If at any time, the income-tax department wants to investigate, it will be able to access the record of telephone calls, emails and faxes. Face Book and WhatsApp communications also travel through the internet. They will be available.

We may consider an internet communication to be **more open than a post card**. Consider a person who sends post card from Mumbai to Assam. The post card will pass through the hands of, say, ten employees of the postal department. These ten employees may be able to read the post cards. Once the post card reaches the addressee, the matter ends. However, in the case of internet communication, any number of people can have access to the communication. The addressee may or may not receive the communication. After receipt, the addressee may delete the communication from his computer / mobile phone. But the ISP would have stored it for the next ten years. Beware. Whatever you do on the internet is available to several regulatory agencies and to several hackers.

Note:

It may be noted that solitary instructions do not amount to shifting of the POEM. Once in a while, it may be necessary to give some instruction from within India. Legally it should not be a problem.

There is a substantial different between (i) **Management control** which is exercised by directors; & (ii) **owner / shareholder control** which is exercised by shareholders. The ownership control will of course remain in India. That should not affect POEM.

18. Non-Corporate Entity:

Creating any Non-Corporate entities abroad will be even more risky. Any trust, partnership firm, Association of Persons (AOP), Body of Individuals (BOI) etc. will be covered by Section 6 (2). As per Section 6(2), even if a small **fraction of its management and control** is situated in India, it will be treated as Indian Resident. All consequences discussed above will follow.

In USA 'S' Corporations are allowed. Many countries permit LLCs which are treated as transparent entities. All these entities will be directly taxable in India (If Indian residents manage the same even partially.).

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19. Conclusion:

POEM will now be the factor determining Indian residence of foreign companies. In essence, if a foreign company is managed from India, it will become Indian resident and tax consequences will follow.

This article gives a list of precautions to be taken. Where it is not practical to take majority of these precautions, it will be better to treat the SPV as an Indian resident. Start preparing books of accounts and file returns. Pay advance tax etc.

Of course, wait till the Finance Bill becomes Finance Act and relevant rules etc. are announced.

Please see Annexure 1 below.

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Annexure 1 - Definitions of "Residence"

1. Under the Income-tax Act, 1961, the definition is as under:

Residence in India.

Section 6. For the purposes of this Act, -

- (1) An individual is said
- (2) A Hindu undivided family
- (3) A company is said to be resident in Indian in any previous year, if -
 - (i) it is an Indian company; or
 - (ii) during that year, the control and management of its affairs is situated wholly in India.

2. Direct Taxes Code, 2009 provided the definition as under.

Residence in India.

Section 4 (1) An individual shall be resident

(2) The provisions of clause (b) of sub-section (1) shall

(3) A company shall be resident in India in any financial year, if -

- (a) it is an Indian company; or
- (b) its place of control and management, at any time in the year, is situated wholly or partly, in India.

3. Direct Taxes Code Bill 2010 proposed a definition as under:

Section 4 (b): its place of effective management, at any time in the year, is in India.

Section 314 (192) "place of effective management" means -

- (i) the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
- (ii) in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

4. Finance Bill 2015 - as presented on 28th February, 2015 proposed as under:

Section 6 (3) 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, at any time in that year, is in India.

Explanation - For the purposes of this clause “place of effective management” means 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.

5. Finance Bill 2015 - as moved on 30th April, 2015 proposed as under:

Section 6 (3) 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, in that year, is in India.

Explanation - For the purposes of this clause “place of effective management” means 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.

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