



Intra Legem

POEM - PLACE YOUR MANAGEMENT EFFECTIVELY!

January 31, 2016

Introduction

The Indian Budget 2015 introduced a new concept of place of effective management ("**POEM**") causing some anxiety in the corporate sector of India including the investors and stakeholders. POEM is viewed as one of the most important changes introduced under the Finance Act, 2015

Existing Provisions

Income in India, like in many other countries, is taxed both on the basis of source and residency. In terms of the existing provision under Section 6(3) the Income Tax Act, 1961 (the "**Income Tax Act**") an entity is to be considered as resident in India in any previous year, if (i) it is an Indian entity, and (ii) control and management of its affairs, during that year, is situated in India. The expression "that year" here would mean the previous year for which the income of any person is subjected to tax.



This provision covers within its ambit an Indian entity and a foreign entity. While an Indian entity being resident of India becomes automatically subjected to tax in India; for a foreign entity to be taxed in India, the test of control and management comes into play.

A foreign entity becomes resident in India during that year, if the control and management of its affairs were situated "**wholly**" in India.

Need for POEM

In case a foreign assessee can demonstrate that in a previous year a part of control and management of its affairs is outside India, the same is sufficient to make the foreign entity a non-resident entity under the Income Tax Act, essentially making it non-eligible to be taxed in India.

Taking advantage of this, many shell companies/ intermediary companies were set-up before acquiring or commencing business of foreign firms. While the most of the effective control and management of such shell companies/ intermediary companies was from India, part control and management was shown to have taken place overseas.

The existing provisions of the Income Tax Act therefore could not achieve the purpose it intended to achieve, i.e. tax a foreign entity essentially controlled and managed from India even if not entirely.

To plug the loophole, the Ministry of Finance proposed a change to the existing provision of the Income Tax Act by introducing the concept of POEM to determine the residential status of a foreign entity and tax such foreign entity in India so long as its POEM is in India.



What is new in this POEM

POEM states that a person being a company shall be said to be resident in India in any previous year, if (i) it is an Indian company; or (ii) its place of effective management, during that year, is in India. Any company which is recognized as a resident company in India in the previous year in turn will be taxable in India.

POEM here has been defined to mean a place where the key management and commercial decisions as are necessary for the conduct of the business of an entity as a whole are in substance made.

The POEM provisions when initially proposed in the Finance Bill, 2015 were much wider and onerous and provided that a person being an entity shall be resident in India in any previous year, if (i) it is an Indian entity; or (ii) its place of effective management, at any time in the previous year, is in India. The expression "any time" used in the amended section was quite wide and virtually all the foreign

companies, with even one instance of control and management taking place from India anytime during the previous year could have been taxed in India.

Taking into account the draconian implication of the term "any time", the provision was amended, and the expression "any time" was dropped and the amended provision finally found its way in the Income Tax Act.

Recently, the [Central Board of Direct Taxes \(CBDT\)](#) has issued the much awaited detailed draft guidelines which seek to provide guidance on determination of POEM. The draft guidelines provide the basis on which POEM of a company can be determined by taking into consideration whether or not the company is engaged in active business outside India. A company is said to be engaged in active business outside India when the majority of the Board meetings are conducted outside India or where the key management decisions are not taken in India, and more than 50% of the total asset of the



company are situated outside India. When the company is engaged in active business outside India, POEM of a company will also be construed to be outside India, which will exempt such companies from being taxed in India.

Where POEM is in India, the company will be treated as Indian resident and the global income of such entity will be taxable in India. Consequently, such foreign companies will have to file its annual tax returns and audit reports with the Indian tax department for assessment, failing which the global income will be considered as undisclosed income and such company will be considered to be an assessee in default.

Possible Safeguards for POEM

While the amended provisions of POEM will come into effect from April 1, 2016 with prospective effect, it is advisable that the corporate entities make some conscious effort in order to avoid falling in the trap of POEM.

For any corporate entity, the Board of Directors and the key personnel of the company are usually the face of the company. They are responsible for taking management and commercial decisions of the company. In order to tackle the issue of POEM, the Board of Directors of a foreign company should be independently constituted without any involvement of an Indian entity.

Alongside, the Board of Directors of a foreign company, the key personnel should be accorded complete autonomy and power to make "independent" decisions as may be vital for the functioning of the company. Even the meeting of the Board of Directors of a foreign entity and its business decisions should be taken in the overseas jurisdiction.

After the meetings, the detailed minutes of the Board meeting should be maintained overseas, which can reasonably and sufficiently demonstrate that the decisions indeed were taken by an independent body not connected with an Indian entity, after proper deliberation and consensus within the Board members.



Internationally

The provisions of POEM to be brought into effect (*which may concern the tax planners*) are not unique to India. In several other countries such as Italy, Spain, Mexico, Greece, Canada, Germany, Japan and USA, the principle of place of effective management is applied to determine residential status of an entity by considering factors such as the location of head office of the entity, base country where the key personnel and Directors are situated and place where majority decisions are taken by the Directors. POEM is also recognized and accepted by the Organisation of Economic Cooperation and Development (**OECD**), an international forum providing a platform to compare policy experiences to identify good practices and coordinate domestic and international policies of its members.

Since POEM is a globally recognized concept, there are well set guiding principles for establishing POEM. Such determination is based on all relevant Facts (and not isolated instances) and the test always is of "substance over form". As far as India is concerned, it is proposed that in due course, a set of guiding principles would be implemented (*which are currently under discussion*) for the benefit of both the assessee and the tax authority.

Considering that the concept of POEM is not captured in the double taxation avoidance treaties, the same may not be recognised by these countries. It therefore needs to be seen whether the companies will end up paying taxes twice on the global income of the overseas business i.e. in the country where they earn income and also in India.



Conclusion

Amongst several factors which are considered at the time of setting up a new business or structuring of a business, ease of doing business and tax risks are always important factors for the final decision to be taken by the management. With the amended provisions in place (to become effective from April 1, 2016), it will be essential for the foreign entity (*irrespective of having place of business in India or not*) to organize its business considering the implications of POEM. An effective planning, coupled with tax and legal advice may help a foreign entity to achieve its objective and smoothly conduct its business in India. However, it is a little early in the day to say whether the same may help a foreign entity not to fall within the purview of POEM or increase the instances of litigation on the subject matter. One can only wait and watch!

Contributed by:

Shisham Priyadarshini, Partner: shisham@rajaniassociates.net

Amish Shroff, Principal Associate: ashroff@rajaniassociates.net



Contact Us

Rajani Associates

Advocates & Solicitors

Krishna Chambers

59 New Marine Lines

Mumbai 400020, India

t: +91 22 4096 1000

e: intralegem@rajaniassociates.net

w: www.rajaniassociates.net

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