

CBDT issues final guidelines for determination of POEM

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In brief

The Central Board of Direct Taxes (CBDT) has issued a Circular¹ laying down the final guidelines for determination of the Place of Effective Management (POEM) of a company. The final guidelines take forward the concept laid down in the draft guidelines for POEM determination based on the bifurcation of companies engaged in active business outside India and other companies. It further provides clarification on the following areas.

- Computational aspects for the determination of ‘active business outside India’ test.
- Exclusion for shareholder decisions by the parent company.
- Adherence to global group policies on accounting, HR, IT, supply chain and routine banking operations shall not lead to POEM in India.
- Broader strategic and policy decisions to be relevant in determining POEM, as against routine operational decisions for oversight of day-to-day business operations.
- The Assessing Officer shall initiate POEM determination only after prior approval of the Principal Commissioner/ Commissioner. The decision on upholding the determination of POEM needs to be approved by a collegium of three Principal Commissioners/ Commissioners.
- The POEM guidelines shall not apply to companies having turnover or gross receipts of INR 500 million or less in a financial year (this has been provided in the CBDT press release dated 24 January, 2017, but has not been stated in the guidelines).

A few illustrations have also been provided to highlight the applicability of principles enumerated in the guidelines.

In detail

Pre-cursor

The Finance Act, 2015 amended the residency test for a company, wherein a company would be considered as resident in India if it is an Indian company, or if the company’s POEM is in India during the relevant year. The POEM was defined 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.”

The Explanatory Memorandum to the Finance Act, 2015 mentioned that the CBDT would issue certain guiding principles for the determination of POEM for the benefit of taxpayers and the tax administration. Accordingly, the CBDT issued draft guidelines in December 2015 for the determination of POEM and invited comments and

suggestions on the guidelines from the stakeholders.

The Finance Act, 2016 had deferred the applicability of POEM provisions, and they are now effective from 1 April, 2016 (i.e., Financial Year 2016-17). The CBDT has now issued the final guiding principles for the determination of POEM. These final guidelines are broadly in line with the principles laid down in the draft guidelines, with a few

¹ Circular No. 6 of 2017 dated 24 January, 2017

illustrations being added and some guidance being provided with respect to areas such as shareholders' decisions, adherence to group global policies, meetings by way of circular resolutions, routine operational decisions vis-à-vis key management and commercial decisions, and certain computational aspects for the determination of active business outside India test. The final guidelines provide for the following aspects for determination of POEM.

General guidance

- The process of determination of POEM would generally be:
 - based on facts and circumstances;
 - driven by substance over form;
 - based on the place where decisions are taken, rather than the place of implementation of the decisions.
- Day-to-day routine operational decisions shall not be relevant for the determination of POEM.
- An entity may have more than one place of management, but it can have only one POEM at any point of time.
- The POEM will be required to be determined on a year-to-year basis.

Guidance for companies engaged in active business outside India

Determination of “active business outside India”

A company would be considered as engaged in an active business outside India if the passive income of the company is not more than 50% of its total income, and

- less than 50% of its total assets are situated in India; and

- less than 50% of the total number of employees are situated in India or are resident in India; and
- the payroll expenses incurred on such employees is less than 50% of its payroll expenditure.

Passive income of a company is defined to mean the aggregate of

- income from transactions where both purchase and sale of goods is from/ to its associated enterprises; and
- income by way of royalty, dividend, capital gains, interest or rental income.

The final guidelines have clarified that income by way of interest shall not be considered passive income in case of a regulated company engaged in the business of banking or a public financial institution. The income for the above purpose shall be as computed for tax laws in the country of incorporation, or as per the books of accounts (if no such tax computation is required).

Guidance has also been provided in the final guidelines for the computation of value of assets, number of employees and payroll expenses. It is relevant to note that ‘employee’ shall include persons who perform tasks similar to those performed by employees, though not employed directly by the company.

For the above test, the average of the data of the previous year and two years prior to that shall be considered. If the company has been in existence for a shorter period, the data of such period shall be considered. The final guidelines provide that where the accounting year for tax purposes is different from the previous year, then the data of the accounting year that ends during the relevant previous year and two accounting years preceding it shall be considered.

POEM guidelines for “active business outside India”

For a company engaged in active business outside India, the POEM will be presumed to be outside India if a majority of the meetings of the board of directors of the company are held outside India. However, if it is established that the board of directors are standing aside and not exercising their powers of management, and such powers are being exercised by either the holding company or any other person resident in India, then the POEM shall be considered to be in India.

The final guidelines have clarified that for this purpose, merely because the board of directors follow the general and objective principles of the global policy of the group laid down by the parent entity, which may be in the field of payroll functions, accounting, human resource functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group of entities *per se*, would not constitute a case of board of directors of the company standing aside.

Guidance for companies not engaged in active business outside India

For companies not engaged in active business outside India, a two-stage process for the determination of POEM is provided as follows.

- Identifying or ascertaining the person or persons who actually make the key management and commercial decisions for the conduct of the company's business as a whole.
- Determination of the place where these decisions are being taken.

The following guiding principles are provided in this context, none of which could unilaterally decide

the POEM but will have to be considered on a holistic basis.

Location of meeting of the company's board

The place where the company's board regularly meets and makes decisions can be considered as the POEM, provided that the company's board:

- retains and exercises its authority to govern the company; and
- does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.

If the key decisions by the directors are being taken in a place other than the place where the formal meetings are being held, then such other place would be relevant for the determination of POEM.

If the board has *de facto* delegated the authority to make key management and commercial decisions for the company to the senior management or any other person, including a shareholder, promoter, strategic/ legal/ financial advisor, and does nothing more than ratify such decisions, then the POEM would be the place where such senior management or other persons make those decisions. The term 'senior management' has been defined and it includes key managerial personnel such as managing directors, CEOs, CFOs and heads of various divisions/ departments, such as sales or marketing.

Executive committee

If the company's board has delegated (*de jure* or *de facto*) some or all authority to an executive committee consisting of members of the senior management, the location where the members of such committees are based, and where that

committee develops and formulates the key strategies and policies for approval of the board, will be considered as the POEM.

Location of the head office of a company

A company's head office would be a very important factor in the determination of its POEM. The head office of a company has been defined as "*The place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.*"

In this connection, the following points have been provided for determining the location of the head office of the company.

Situation	Head office location
The company's senior management and their support staff are based in a single location, which is held out to the public as the company's principal place of business or headquarters.	Such principal place of business or headquarters.
The company is more decentralised, and hence, the senior management operates from time to time from offices in various countries.	The location where these senior managers are primarily or predominantly based; or normally return to, following travel to other locations; or meet when formulating or deciding key strategies and policies for the company as a whole.
The members of the senior management operate from different locations on a more or less permanent basis, and participate in various meetings <i>via</i> telephone/ video conferencing.	The location, if any, where the highest level of management (e.g., managing director and financial director) and their direct support staff is located.
Where the senior management is so decentralised that it is not possible to determine the company's head office with reasonable certainty.	The location of the head office would not have much relevance in determining the POEM.

Use of modern technology

If, due to the use of modern technology, it is determined that the physical location of the board meetings or executive committee meetings may not be where the key decisions are, in substance,

made, then the place where the directors or persons taking decisions or where the majority of them usually reside may also be a relevant factor.

Circular resolution

The final guidelines provide that in case of circular resolution or round robin voting, factors such as its frequency of use, the type of decisions made in that manner, and the location of the parties

involved in those decisions, etc. are to be considered. It would be required to determine the person who has authority, and who exercises such authority to take decisions. The place of location of such person would be more important.

Shareholders’ decisions

The final guidelines have clarified that the decisions made by shareholders on matters that are reserved for shareholder decisions under the company laws are not relevant for the determination of POEM. Those decisions typically affect the existence of the company itself, or the rights of the shareholders as such, rather than the conduct of the company’s business from a management or commercial perspective, and hence, are generally not relevant for the determination of POEM.

The shareholders’ involvement can, in certain situations, turn into that of effective management through a formal arrangement by way of shareholders’ agreement, etc., or by way of actual conduct. For instance, if the shareholders limit the authority of board and senior managers of a company, and thereby, remove the company’s real authority to make decisions, the shareholder guidance transforms into usurpation, and such undue influence may result in effective management being exercised by the shareholder.

It has to be determined on case-to-case basis if shareholder

involvement is crossing the line into that of effective management.

Secondary factors

If the above factors do not lead to a clear identification of the POEM, the following secondary factors can be considered.

- place where the main and substantial activities of the company are carried out; or
- place where the accounting records of the company are kept.

Factors that do not by itself establish POEM

The determination of POEM is to be based on all relevant facts related to the management and control of the company and not on the basis of isolated facts, which do not establish effective management, as illustrated below.

- A foreign company is completely owned by an Indian company.
- Foreign company has a permanent establishment in India.
- One or some of the directors of a foreign company reside in India.
- Local management being situated in India, in respect of activities carried out by a foreign company in India.
- The existence in India of support functions that are preparatory and auxiliary in character.

Other points

- The above principles are for guidance only and no single principle will be decisive in itself.

- The principles have to be seen with reference to activities performed over a period of time and no “snapshot” approach is to be adopted.
- If, based on facts and circumstances, it is determined that during the previous year, the POEM is in India and also outside India, the POEM shall be presumed to be in India if it has been mainly/ predominantly in India.
- The final guidelines provide that the Assessing Officer shall seek the prior approval of the Principal Commissioner or the Commissioner, as the case may be, before initiating any proceedings for POEM determination.
- An Assessing Officer can hold a company incorporated outside India, on the basis of its POEM, as being resident in India only after seeking the prior approval of a collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned. The collegium so constituted shall provide an opportunity to the company of being heard before deciding the matter.

Illustrations

There are five illustrations provided in the guidelines, which highlight the applicability of certain principles covered in the guidelines. These illustrations deal with following key aspects.

Illustration No.	Key aspect
Example 1	Only those transactions where both, purchases and sales are with associated enterprises, shall be considered for determination of passive income.
Example 2	If payroll expense incurred on employees situated in India exceeds 50% of total payroll expense, the foreign company shall not be considered as engaged in active business outside India.
Example 3	For entities engaged in active business outside India, if the majority of board meetings are held outside India, the POEM shall be considered outside India, even if all directors are Indian residents.

Example 4	If the majority of decisions are taken by the Indian parent company, and the foreign company's senior management is merely signing the contracts, the POEM shall be presumed to be in India, even though the said company is engaged in active business outside India and the majority of its board meetings are held outside India.
Example 5	Merely because the POEM of an intermediate holding company is in India, the POEM of its subsidiaries shall not be taken to be in India. The POEM shall be determined for each subsidiary separately.

The takeaways

- These final guidelines have been long awaited, and are broadly on the same lines as the draft guidelines, with bifurcation for companies engaged in active business outside India and other companies.
- Providing guidance on aspects relating to shareholders' decisions, adherence to group global policies, meeting by way of circular resolutions, routine operational decisions vis-à-vis key management and commercial decisions, is a welcome move.
- The monetary threshold for non-applicability of POEM

guidelines to companies with turnover or gross receipts of INR 500 million or less in a financial year (as laid down in the press release), needs to be incorporated in the guidelines.

- As the determination of POEM is dependent on facts and circumstances, the principles laid out involve a holistic factual analysis, and should not be applied in an isolated manner. The guidelines are applicable for current FY 2016-17, unless the Budget on 1 February, 2017 defers the applicability to FY 2017-18.
- The notification with respect to applicability of various provisions of the Income Tax Act for a foreign company

which is treated as resident on account of its POEM being in India, as stipulated in the Finance Act, 2016 is awaited, and the same should be released soon to provide clarity.

- With the release of the final guidelines for POEM determination, one will now have to wait and watch the position with respect to the adoption of Controlled Foreign Company (CFC) rules as stated in the BEPS action plan.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor.

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