The Finance Ministry’s Location Test is Neither Consistent nor Effective

BY ASHRITA PRASAD KOTHA ON 28/01/2016

The Finance Act, 2015 amended Section 6(3)(ii) of the Income Tax Act, 1961 to introduce a new test called ‘place of effective management’ (POEM) to determine when a company is a resident in India for tax purposes. This change targets foreign companies as companies incorporated in India are residents for tax purposes, anyway. In simple words, if it is shown that a foreign company’s effective management is in India during the relevant financial year it would be considered resident under Indian tax laws. The implication of this classification is that such a company will be liable to pay tax in India at the rate of 40% on its global income.

The test which came into effect from April 1, 2015 has been defined 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”. The language of this definition mirrors the commentary to the OECD’s Model Convention With Respect to Taxes on Income and on Capital, as acknowledged by the government in the explanatory memorandum to the Finance Bill, 2015.

On December 23, 2015 the government has, almost nine months after the test came into effect, published draft guidelines to aid interpretation and application of the test. Comments to the draft guidelines were invited from stakeholders and general public until January 9, 2015.
The guidelines are a welcome step as it spells out the government’s approach, but it also throws up a number of concerns.

**Few steps forward?**

Firstly, the guidelines make it amply clear that the term “in substance made” occurring in the definition is to be given due regard. While applying the POEM test, a holistic approach preferring substance over form is to be adopted. If it is found that the board of directors meets only to fulfil legal formalities or ratify decisions then POEM will be at the place where the decisions are actually made (be it by senior management, an executive committee or any other person).

Secondly, the guidelines also account for technological innovations. It shifts the focus from a meaningless search for the physical location of meetings by acknowledging that many meetings nowadays take place virtually.

**How effective is the POEM test?**

One of the drawbacks of the guidelines is that while it clarifies that POEM will be an investigation into the place where actual management occurs, it does not define the crucial phrase of ‘key management and commercial decisions’. The lack of clarity is only worsened by the fact that the language used in the guidance is inconsistent. While para 2 of the draft guidelines uses the term ‘key management and commercial decisions’, para 5.2(d) refers to power of formulating key strategies and policies and overseeing implementation on an ongoing basis and para 8.2(c) refers to ‘key company decisions’.

The entire draft guidance on locating effective management will be in vain if we do not know which kind of decisions are covered by the test. As the analysis is to be facts specific, lack of adequate guidance may lead to unwarranted litigation.

Furthermore, the guidelines seek to identify a new category of companies; those engaging in ‘active business outside India’. The categorisation will be based on proof that less than 50% of the company’s income is passive, less than 50% of assets and employees are in India and payroll expenditure on Indian employees is less than 50% of overall payroll expenditure. If a company fulfils the prescribed quantitative threshold, it will be presumed to be non-resident as long as the
majority of its board meetings are held abroad. The presumption may be rebutted if the board does not exercise *de facto* powers of management.

However, the said quantitative exercise is to be undertaken on an analysis of the average of three years data, including the concerned financial year. This appears unjust as the guidelines have been notified almost at the end of this financial year and spring a last minute surprise by including data from two previous years. It operates retrospectively, to such extent. Considering the widespread criticism against the retrospective amendments introduced post the 2012 Supreme Court ruling in Vodafone, is this really desirable?

Finally, the guidance note begins by stating that there cannot be more than one centre of POEM but ends up conceding that there can be such a situation. This matter ought to be clarified.

**Sisyphean effort?**

While we can hope that the concerns flagged here are considered before the guidelines are finalised, there is a more fundamental question that begs an answer.

The amendment is justified as being a step towards aligning the domestic test with that used in most of our double taxation avoidance agreements. The test in our double taxation avoidance agreements is meant to play the role of a tie-breaker when a company is classified as a resident in both the signatory countries. If all countries were to start emulating the Indian model (of using POEM domestically and internationally), would not the efficacy of POEM as a tie-breaker be reduced to nought?

*Ashrita Prasad Kotha is Assistant Professor & Assistant Director, Centre for Comparative and International Taxation, Jindal Global Law School*