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Date of Publishing: December 18, 2015

Place of Effective Management - Select Practical Issues**CA VANDANA SHAH***

In this article, the author highlights some practical issues faced globally with respect to Place of Effective Management, and hopes that some of these issues will be addressed by the yet to be announced rules on the subject.

Introduction

The Finance Act, 2015 has amended the definition of "Resident company" to provide that a company whose place of effective management in the concerned year is located in India, will be considered as a tax resident of India. The term "place of effective management" (POEM) has been defined to mean a place where key management and commercial decision that are necessary for the conduct of the business of an entity as a whole are, in substance made. Further, it is proposed to provide a set of guiding principles to be followed by taxpayers as well as tax administration in determination of POEM.

While the determination of POEM is completely fact based exercise, and would also depend on the rules to be notified in this regard, there are certain practical issues generally faced in relation to POEM as has been experienced in the past - in India and overseas. This Article attempts to outline some practical issues generally encountered in the context of POEM of the company.

Some Practical Challenges

1. **"Effective management" in case of Parent - Subsidiary relationship**
 - 1.1 It is a common situation that parent company, being the shareholder of the subsidiary company, may normally influence the actions of subsidiary company. Further, the parent company may be responsible for overall business strategies and major corporate decisions of the subsidiary company and in fact in certain situations, some decisions of the subsidiary company may have to be approved by the parent company. Having regard to special relation between the parent and subsidiary company, one common issue that arises for consideration is whether the place of effective management of subsidiary should be considered to be situated in the State of the parent company.
 - 1.2 Reference in this regard can also be made to "Discussion Draft - Place of Effective Management Concept : Suggestions for changes to the OECD Model Tax Convention, dated 27th May 2003". The OECD view is that "...if there is a person such as a controlling interest holder (e.g. a parent company or associated enterprise) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the place of effective management will be where that person makes these key decisions. For that to be the case, however, the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group's activities (e.g. the type of decisions

that a parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group)."¹

1.3 Reference can also be made to following discussion on Shareholders as outlined in Draft Interpretation No. 6 (Issue 2) - Resident - place of effective management (companies), issued by South African Revenue Service (SARS).²

"There is a distinction between shareholder guidance or influence and usurpation. Influence does not constitute effective management but undue influence may. For example, if the board considers what the shareholder has recommended and independently makes its own decision, this would not constitute usurpation even if the decision made by the board is in line with the shareholder's recommendation. The important point which has to be established is whether the board independently makes its own decisions or is merely implementing what the shareholder has already decided for the company and in that way does not actually make decisions. Depending on the facts the line between influence, and merely approving or rubber-stamping may be unclear. Situations in which a shareholder or another party usurps effective management will probably be the exception rather than the norm."

1.4 A parent company is entitled to play its role as the shareholder/parent and accordingly be involved in mere policy formulation of the group activities. Such involvement ought not be treated to draw an inference that the POEM of the subsidiary is situated in the State of the parent. It is only in situations where the parent entity also involves itself in the subsidiary's management, that the risk of a subsidiary having POEM in the State of the parent would be triggered.

1.5 In fact, in some cases where the shareholders actually participated in the management of the company, POEM of such companies has been held to be in the State of shareholders.

1.6 For instance, in a case in the UK, in case of *Unit Construction Co. Ltd v. Bullock (Inspector of Taxes)*³, three wholly owned subsidiary companies were incorporated in Kenya. By their articles of association, powers of management were vested in the directors who were located in Kenya and who could not validly hold meetings in the UK. However, these management powers were not in fact exercised by the local Directors who stood aside in all matters of real importance, so that it was the Board of Directors of the parent company in the UK which effectively made all the decisions. This resulted in the subsidiaries being held to be UK residents.

1.7 Similarly, the District Court in Israel observed that the place of "daily management" should be determined on the basis of factual assessment of where the decisions as to the company's business policies, strategy and daily decisions were taken. *In the concerned case, the management decisions were actually taken by the Israeli resident shareholders of the taxpayer company and subsequently, executed by the company's director in Belgium. Accordingly, the Court held that the company was resident of Israel.*⁴

1.8 Based on the above, the accepted view generally appears to be that so long as shareholders are not influencing the independence of the subsidiary company, the place of effective management should not be considered as situated in the State of parent company. Conversely, in cases where shareholders are the ones calling the shots, the effective management would be considered to be in the State of shareholders.

1.9 All in all, based on the above discussion, the mere parent subsidiary relationship should not lead to an inference that the effective management of a subsidiary is located in the State of parent company, *sans* management participation by the parent.

2. "Effective management" in triangular cases

2.1 One of the peculiar issues that can arise in the context of effective management is the applicability of Double Tax Avoidance Agreement (DTAA) in triangular cases. It is pertinent to note that provisions of DTAA are applicable only to a person who is a tax resident of one of the contracting States. In the case of dual residency of a company, question arises regarding the country of which the DTAA will be applicable to the company. The issue assumes more significance when the DTAA contains different maximum withholding tax rates.

2.2 To illustrate - Suppose a company "A" incorporated in Singapore is considered to have a place of effective management in India and is receiving interest from Netherlands. In such cases, issue arises whether

Singapore-Netherlands DTAA or India-Netherlands DTAA will be applicable for the purpose of determination of withholding taxes in Netherlands.⁵

- 2.3 Here, a possible approach is that one refers to India-Singapore DTAA first to determine the tax residency of the company. The tie-breaker test under the Article 4 of India-Singapore DTAA provides that a company shall be considered as a tax resident of country in which its effective management is located, in cases of dual residences.⁶ Accordingly, the company will be considered as a tax resident of India (its place of effective management being located in India). As a result, under this approach, a view could be adopted that India-Netherlands DTAA should be applicable for the purpose of determination of withholding taxes.
- 2.4 Another linked issue relates to the claim of foreign tax credit. Once the company is considered as Tax Resident in India, its global income will be taxable in India and the corresponding foreign tax credit may have to be claimed in India.
- 2.5 Conversely, in cases where interest is paid by a dual resident company to a foreign company, issue arises as regards the DTAA to be adopted for the purpose of determining withholding taxes by such dual resident payer. To illustrate - Consider the above example - in case company A pays interest to a Netherlands company, question arises whether interest will be deemed to be sourced in India and will be subject to Indian withholding taxes or the withholding tax provisions of Singapore will apply.
- 2.6 The situation may be further aggravated if the dual resident company has a PE situated in another country, resulting in involvement of one more DTAA to analyse the applicable tax implications and related availability of foreign tax credit.
- 2.7 Importantly, it is also quite possible that in such scenarios, the tax cost of the dual resident Company may increase merely because of the change in the DTAA. For instance, the withholding tax rate may be higher in one DTAA as compared to another. Similarly, the scope of income (*e.g.* royalty/FTS) may be widely defined in one DTAA as compared to another, triggering additional tax liability. Also, the tax cost may be a significant consideration in case of no treaty countries, and the applicability of POEM provisions could result in double taxation of same income in some cases.
- 2.8 Further, there may be several challenges for a foreign company having income from various countries in claiming foreign tax credit. Continuing the earlier example, taxes may have been withheld under the DTAA between Singapore and various concerned countries. However, the credit may have to be claimed in accordance with Indian tax provisions. Similarly, the computation of taxable income of the Singapore company may be required to be in line with ICDS⁷ whereas the income may have been computed in different manner at the time of withholding of taxes.

3. "Effective management" in cases involving use of Advanced Technology

- 3.1 In today's global environment, it is often observed that companies conduct their management through virtual Board of Director and Shareholder's meetings. A company could be managed *via* videoconferencing facilities by Directors who live in several different countries, or alternatively, the Directors could meet at several different locations. In such a situation, it may be difficult to pin point exactly the place of effective management of the Company.
- 3.2 Guidance in this matter can be obtained from the OECD Draft Discussion Paper issued in the context of "The Impact of The Communications Revolution on the application of "Place of effective management" as a Tie-Breaker Rule" dated 30th June 2001. The Discussion Paper provides that following options may be considered by Countries for the determination of effective management in cases where the characteristics of effective management may exist in a number of jurisdictions:

- a. **Replace the effective management concept with**

- i. Place of incorporation;
- ii. Place where the directors/shareholders reside and
- iii. The place where economic nexus is strongest

- b. **Refine the place of effective management test**

Following two options have been suggested in the context of refining the existing place of management test:

- i. The determination is on the basis of predominant factors such as where key management and commercial decisions are made in substance, where the most senior person or group of person makes its decisions and where the actions to be taken by the enterprise as a whole are determined.
- ii. In cases where analysis of predominant factors does not produce a single place of effective management, it may be necessary to consider additional factors. Other facts could be:
 - Location of and functions performed at headquarters
 - Information on where central management and control of the company is to be located as contained within company formation documents (articles of association), etc.
 - Place of incorporation or registration
 - Relative importance of the functions performed within the two States; and
 - Where the majority of directors reside.

The provision relating to effective management aboard a ship or boat in relation to shipping enterprise deems the place of effective management to be in the jurisdiction with which the shipping enterprise has its closest links. It may be possible to devise a similar provision to deal with other situations where the place of effective management is mobile. *e.g.* where single Board of Directors meet in different locations.

- c. A hierarchy of tests may be adopted such as place of effective management, place of incorporation, economic nexus and mutual agreement to determine corporate residency.

3.3 The OECD recommends that a case-by-case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies.⁸

3.4 Further, another suggestion by a tax expert⁹ is that the residence of a company should first be determined by reference to the residence of the Directors of the Company that are responsible for the major decisions of the company. Recognizing that this may not always yield a clear result, the proposal contains two backup tests, which may be successively applied if resorting to the first test does not conclusively determine the residence of a company. The first back-up test looks at the residence of the top-level Director or Manager of the company in determining its residence and failing that, a final residual test looks at where the company has its strongest economic nexus, which would ultimately determine its residence. Finally, support may be found in German case law, where Professor Vogel has noted that if corporate residence cannot be determined by reference to other criteria, then "the top-manager's residence will regularly determine the residence of the company".

3.5 The advantage of above test is that a company is nothing more than a function of the people through which it must necessarily act and no matter how much activity a company engages in *via* electronic commerce networks like the Internet, it must do so through the agency of people. These people must necessarily reside somewhere and it is argued that it is where these individual participants reside which ultimately should determine where a company is regarded as being a resident.

3.6 Thus, the consensus on this aspect appears to be that the primary consideration should not be the location of interactions (decisions), but the residence of the people who put into effect those decisions. Accordingly, while one may consider the traditional test for determination of effective management (*i.e.* the place where key management decisions are taken), in the digital world, in the absence of clear determination of effective management, practically, the residence of place of senior most Director/Manager calling the shots of the company may be considered.

4. "Effective management" - Substance over form

4.1 The doctrine of substance-over-form has a universal applicability and the concept of effective management is no different. In the Indian context, the risk of having insufficient substance abroad while claiming that the effective management of a company is located outside India could result in such foreign company being considered to be a resident in India. The Indian tax authorities in all likelihood will consider the *de facto* control and management of the company and take into account several factors in this regard.

4.2 The OECD also recommends the substance-over-form principle to determine tax residence. The place of

effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management.¹⁰

4.3 There are cases where the key management and commercial decisions necessary for the conduct of the entity's business are in substance made in one place somewhere by a person or group of persons but are formally finalized somewhere else by it or by another person or group of persons. In such cases, it will be necessary to consider other factors. Depending on the precise facts and circumstances of the case, these other factors could include:¹¹

- a. *Where a Board of Directors formally finalizes key management and commercial decisions necessary for the conduct of the entity's business at meetings held in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State.*
- b. *If there is a person such as a controlling interest holder (e.g. a parent company or associated enterprise) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the place of effective management will be where that person makes these key decisions.*
- c. *Where Board of Directors routinely approve the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity. In distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.*

4.4 Based on OECD Commentary and some of the relevant judicial precedents, the aspects that typically need to be considered in determining the effective management of company include:

- a. While the place of board meetings/senior personnel meetings is relevant for determination of effective management, it is equally relevant to note the level of decisions made in such meetings. Strategic decision making as against the day to day operational decision making may be more relevant for the purpose of determining POEM.
- b. The qualifications, experience and the knowledge of the Directors in relation to various decisions taken for the company assume lot of significance. Having merely rubber stamp Directors may not be conclusive for determination of POEM.
- c. The minutes of meetings are often referred to by income tax authorities to determine where the important decisions are actually taken as against mere ratification of decisions taken by someone else at some other locations.
- d. The place of negotiation and signing of important business decisions may be relevant in certain situations to determine POEM.
- e. The business operations, employees, performance of the Company etc. may play a relevant role in determining whether or not the company is merely a post box company and consequently, also the POEM of the company.
- f. The correspondence place of the company may assume significance in determining POEM of the company in certain cases.

Concluding Remarks

With the introduction of concept of effective management in India, foreign companies having their POEM in India would become liable for undertaking various tax compliances and importantly, would also be subjected to various practical issues in India. The implications could be right from the requirement of maintenance of accounts in certain situations, compliance with advance tax provisions, withholding tax compliances (including compliances with respect to remittances in their respective local jurisdictions or other jurisdictions), to undertaking tax audit and filing of tax returns in India.

Also, once a foreign company is considered as tax resident in India, one of the key implications would be the applicability of transfer pricing provisions in India. Intra-group transactions entered into by the foreign company with any of its associated enterprises may need to be reported and benchmarked for arm's length nature in India, even if the transactions are not even linked to India. Further, even if such foreign company may have benchmarked the transactions considering the laws of its home country and the country of its associated enterprise, they may yet be required to undertake compliances as per the Indian regulations also. In fact, practically, the benchmarking exercise conducted as per overseas regulations may or may not be accepted by Indian tax authorities.

Further, the requirement of determining the POEM appears to be an annual exercise, and therefore, foreign companies will be required to evaluate their tax residence and associated tax implications in India on a year to year basis. This could also pose a serious practical challenge especially with respect to compliances towards the beginning of the year, when the foreign company would not know whether the POEM for the year would be situated in India or not.

All in all, having the POEM in India has the potential to subject the foreign company to significant tax implications in India, and a POEM exposure would need to be closely examined and also annually monitored. Failing to undertake the necessary compliances could lead to significant additional costs for the foreign company including interest and penalties.

It is hoped that the much awaited rules on the determination of POEM will provide much needed clarity for taxpayers in this regard.

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1. Reference para 24.3 of the Draft Discussion Paper.
2. The comments are to be submitted by 31st July 2015.
3. (1959) 3 ALL ER 831
4. Reference: Portfolio Plus - Case Summary - Yanko Weis Holdings Ltd. v. Holon Income Tax Assessor, Case No. C-1090/06, dated 18th December 2013.
5. The withholding tax provisions under the local tax laws of Netherlands have been ignored for the purpose of this example.
6. The concept of "effective management" is generally dealt in Article 4 (dealing with tax residency) and Article 8 (dealing with profits from international shipping/aircraft business) of DTAA's.
7. Income Computation and Disclosure Standards issued by the Central Board of Direct Taxes; refer Notification No. 33/2015 [F. No. 34/48/2010-TPL]/SO 892(E), dated March 31, 2015.
8. Reference para 24.1 of 2014 OECD Commentary on Model Tax Convention.
9. Reference - Asia-Pacific Tax Bulletin January/February 2005 - A new Three-Tier Proposal for Determining Corporate Residence based principally on Individual Residence - by Dr. Dale Pinto (Associate Professor and Head of Department) (Taxation) in the School of Business Law at the Curtin Business School, Curtin University, Western Australia
10. Reference 2014 OECD Commentary on Model Tax Convention.
11. Discussion Draft on "Place of Effective Management Concept: Suggestions for changes to the OECD Model Tax Convention" dated 27th May 2003.