

Guide to Place of Effective Management Rules for Foreign Companies Owned by Indian Entrepreneurs

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This Presentation gives only an indication of the guidelines on Place of Effective Management. It is not intended to be either complete or exhaustive narration of the subject. For a more detailed discussion on the subject, please read Guide for Indian Entrepreneurs creating a global structure using Holding Company based in Switzerland / Liechtenstein /Singapore.

Preface

- ❖ Modification of The Finance Act, 2016 introduced the concept of Place of Effective Management (POEM).
- ❖ Foreign Companies which have their POEM in India are liable to pay tax in India.
- ❖ Guiding principles issued by Central Board of Direct Taxes (CBDT).
- ❖ Effective from 1st April, 2017.
- ❖ Precautions must be taken by Indian Entrepreneurs while setting up companies abroad.

Overview

- A. Introduction
- B. Active Business Outside India
- C. POEM for ABOI Company
- D. POEM for Non-ABOI Company
- E. Precautions to be taken by Indian Entrepreneurs

A. Introduction

- Section 6(3) of The Income Tax Act, 1961 includes foreign companies with POEM in India into the bracket of resident in India, thereby making them liable to pay tax in India.
- POEM means the place where key management and commercial decisions of the business are taken.
- Foreign Companies set up by Indians are under risk of being taxed under Indian Income Tax Laws.
- Will increase costs of holding & operating companies outside India.

A. Introduction (Continued)

(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.]

Section 6(3), Income Tax Act, 1961 of India

A. Introduction (Continued)

Circular No. 06 of 2017

F. No. 142/11/2015-TPL
Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes

Dated: 24th January, 2017

Subject: Guiding Principles for determination of Place of Effective Management (POEM) of a Company.

Guiding Principles issued by Central Board of Direct Taxes, in relation to Section 6(3), Income Tax Act, 1961 of India

B. Active Business Outside India (ABOI)

- Classification as ABOI or Non-ABOI is the first step towards determining POEM of the company.
- A foreign company classified as ABOI has lower risk of having POEM in India.
- First test for ABOI is passive income of the company.
- If Passive Income \leq 50% of total income, three other tests have to be applied. All four tests must be fulfilled for being ABOI.
- Non-ABOI foreign companies need to pass more stringent examination to escape POEM in India categorization.

B. Active Business Outside India (Continued)

- (a) A company shall be said to be engaged in “active business outside India” if the passive income is not more than 50% of its total income; and
- (i) less than 50% of its total assets are situated in India; and
 - (ii) less than 50% of total number of employees are situated in India or are resident in India; and
 - (iii) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Para 5 (a) of POEM Guidelines issued by CBDT on 24th January 2017

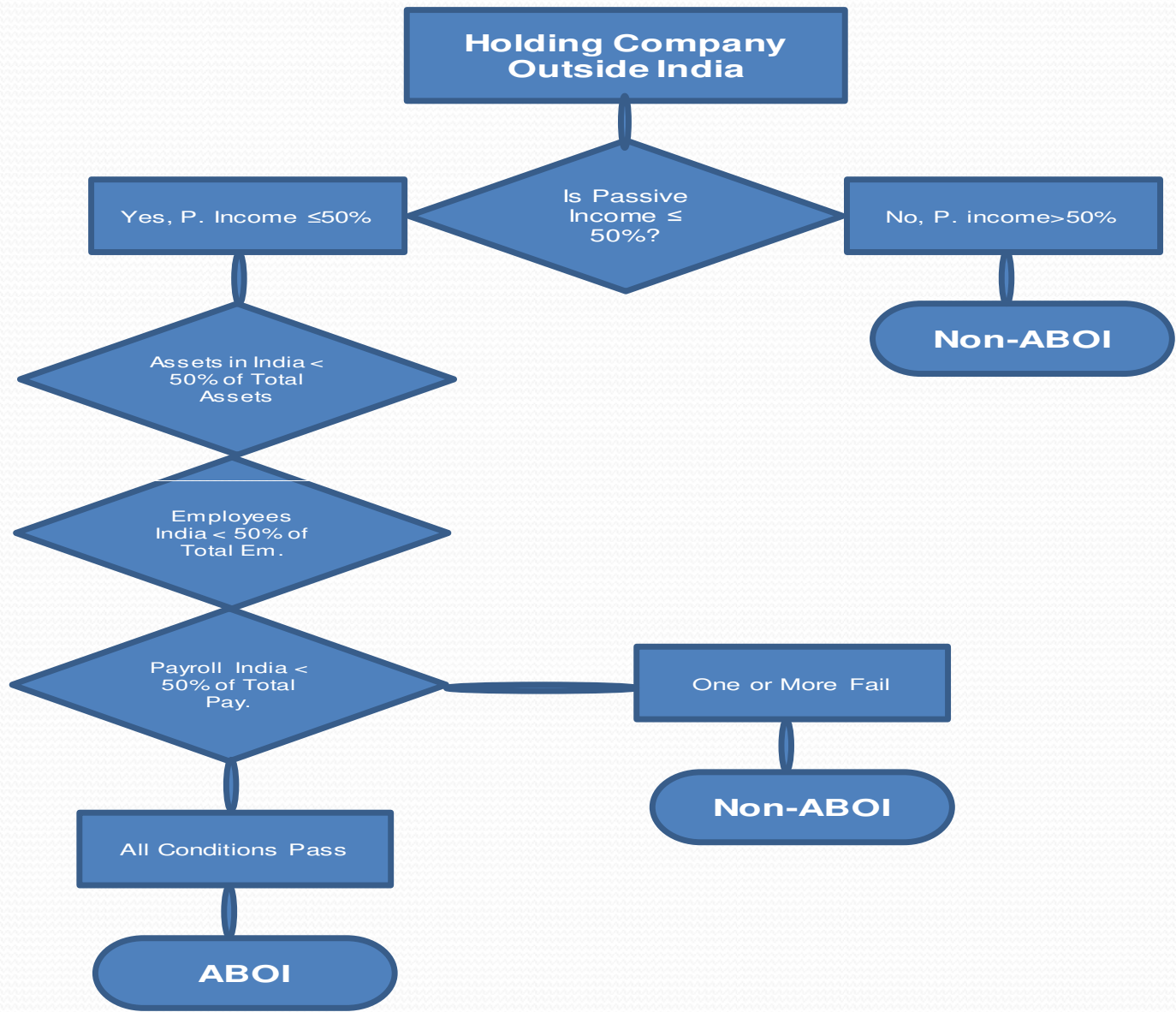
B. Active Business Outside India (Continued)

(c) "Passive income" of a company shall be aggregate of, -

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

However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation.

Para 5 (c) of POEM Guidelines issued by CBDT on 24th January 2017



B. Active Business Outside India (Continued)

Example 1

A company say XYZ is a Swiss based Company. XYZ has an Indian subsidiary named PQR that owns a factory in India. XYZ and PQR collectively have 55 employees. PQR employs 50 employees at the factory in India. XYZ has 5 employees, all in Switzerland. The monthly payroll of Indian employees is about Rs.1.5 Million. Monthly payroll of XYZ in Switzerland is CHF 50,000. Profit before tax of XYZ in a financial year was CHF 200,000 out of which CHF 50,000- comes from dividend from its Indian subsidiary. Value of shares of PQR held by XYZ is estimated as Rs. 1 million. Total assets of XYZ estimated at CHF 1 million. Whether XYZ is a ABOI or a Non-ABOI company?

B. Active Business Outside India (Continued)

Application of ABOI Algorithm

- Passive Income of XYZ is Dividend Income (CHF 50,000). This is less than 50% of total Income.
- Value of shares of PQR is the value of assets held by XYZ in India. This is Rs. 1 million = CHF 15,000 approx, which is less than half of total assets of XYZ.
- XYZ has no employees in India.
- XYZ has no payroll in India

Therefore, **XYZ is a ABOI company.**

B. Active Business Outside India (Continued)

Example 2

Mr. Parag Ahuja, a citizen and resident of India, forms a private company (say, PAL) in Singapore. PAL is wholly owned by Mr. Parag. PAL is involved in future trading and dealing in commodity derivatives. The Company has no associated enterprises. He and one Mr. Sheron Wang, a citizen of Singapore are directors of the company. Mr. Parag has been designated as Managing Director of PAL. As MD, Mr. Parag draws a salary from PAL. The company owns no assets in India. Whether PAL is a ABOI or a Non-ABOI company?

B. Active Business Outside India (Continued)

Application of ABOI Algorithm

- PAL does not have any passive income.
- PAL has no assets in India.
- It may be argued that MD is not an employee. If this view is taken the company has no employees.
- PAL's only payroll is salary paid to MD. So 100% of PAL's payroll is in India.

PAL fulfils 3 out of 4 tests. It fails the payroll test and hence, **PAL will be classified as Non-ABOI.**

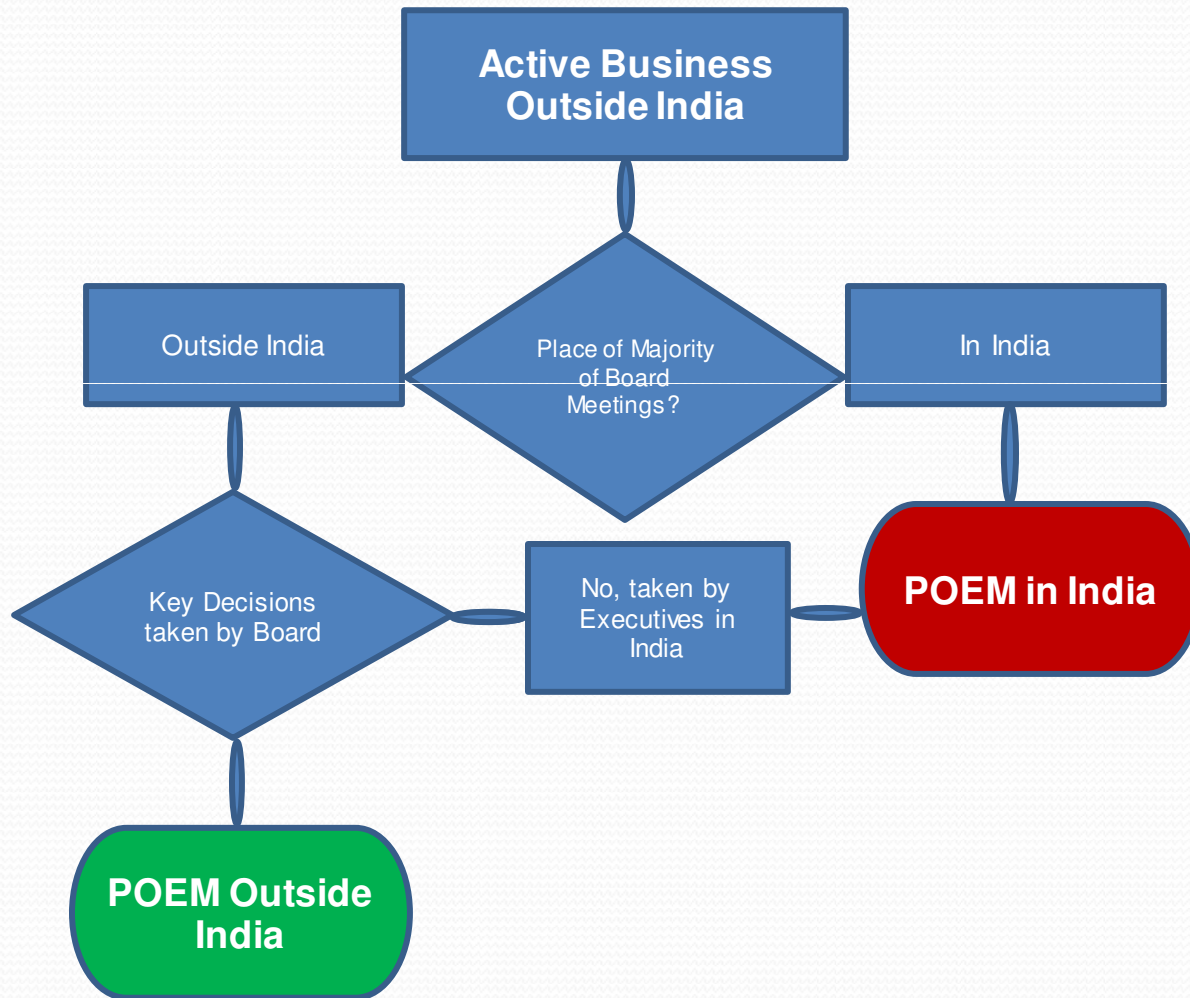
C. POEM for ABOI

Having determined whether a foreign company is ABOI or Non-ABOI, the next step is to determine whether POEM of the foreign company is in India or outside India.

- For determining POEM of ABOI foreign company, consider:
 - Whether majority of Board Meetings are held in India?
 - Whether key decisions of the company are taken by the Board or are they taken by some person sitting in India?

C. POEM for ABOI (Continued)

Algorithm



C. POEM for ABOI (Continued)

Example 1

A European company has its headquarter in Frankfurt. All the directors of the company are European. In a particular financial year, the directors of the European company took fancy to beaches of Indian Ocean and decided to hold one meeting in Goa, the other in Kerala and one more in Port Blair. The company held only one meeting in Frankfurt. The company has no other connection whatsoever with India. It has no assets in India. It derives no business from India. It has no employees in India. What shall be its place of effective management?

C. POEM for ABOI (Continued)

Application of POEM Algorithm

The European Company is a ABOI Company.

The European company will be considered to be having [POEM in India](#) since it has held majority of board meetings in India.

Due to the POEM being in India, Indian tax authorities may tax the company's global income as per Indian income tax law.

C. POEM for ABOI (Continued)

Example 2

One Mr. Patel (resident of Mumbai) has set up a holding company in Switzerland with three Swiss resident citizens as directors. Mr. Patel is not a Director of the company. However, all decisions are taken by Mr. Patel in Mumbai and sent by email to the Swiss Directors who dutifully sign on all documents received from Mr. Patel. What shall be the place of effective management of the Swiss Company?

C. POEM for ABOI (Continued)

Application of POEM Algorithm

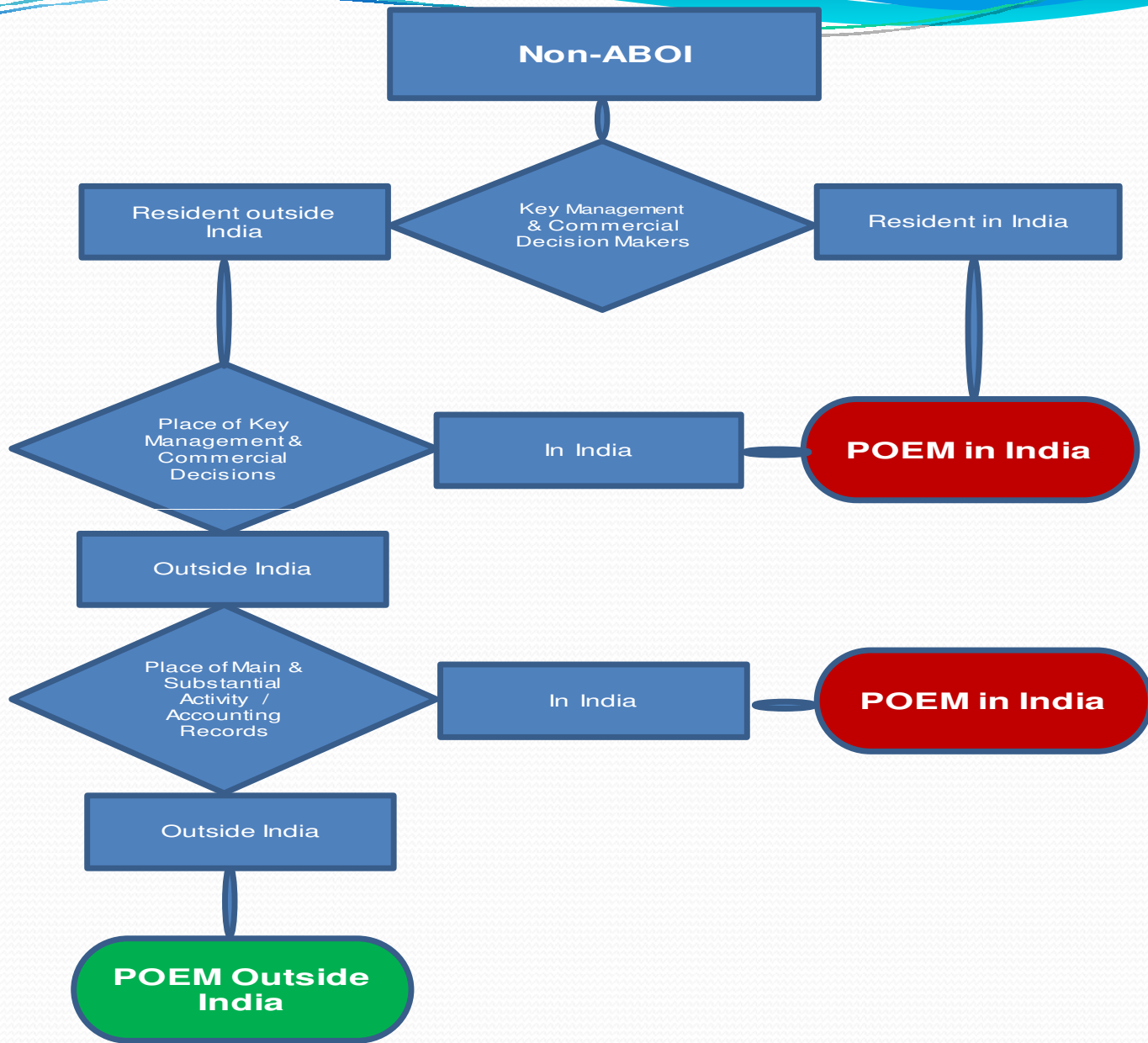
The Swiss company is an ABOI Company.

Key decisions are NOT taken by the Board but are taken by Mr. Patel in India.

POEM of the SWISS company is in India since key decisions of the company are taken by person resident in India.

D. POEM for Non-ABOI Company

- Two step process for determining POEM of Non-ABOI Company.
- Both the criteria must be fulfilled to have POEM outside India.
- The criteria can be summed up as under:
 - Persons making key management and commercial decisions for the company as a whole are NOT residents of India; AND
 - Place where these decisions are made is outside India.
- The Head office of the Non-ABOI Company also plays a substantial role in determining its POEM.



D. POEM for Non-ABOI Company (Continued)

Example 1

An Indian entrepreneur nominates his twenty year old son studying in a university in Australia as one of the directors of an Australian Company owned by him. The Australian company has only the entrepreneur and his son as directors. The Australian company is Non-ABOI.

The young man likely to be treated as dummy based on assumption that all decisions are taken by Indian entrepreneur. **POEM of the Australian Company is in India.**

D. POEM for Non-ABOI Company (Continued)

Example 2

In a particular year Board of Directors of a Swiss Holding Company, say ABC, have two meetings in Mumbai, one in Zurich, one in Sydney and one in New York. ABC's only income is dividends received from subsidiaries in various countries. ABC is Non-ABOI since passive income is 100% of total income.

Maximum meetings of ABC are held in Mumbai and hence **POEM for ABC is Mumbai** and not Zurich where the company is incorporated.

D. POEM for Non-ABOI Company (Continued)

Example 3

- An Indian entrepreneur owns PQM, a Singapore based holding company. PQM is Non-ABOI since its income is from dividends.
- His USA-based uncle and UK-based aunt are Directors of PQM.
- A Singapore professional is Resident Director.
- Resident Director is serving on part time basis at a nominal fee; US based Director plays active role and also receives handsome salary.

Difficult for PQM to claim that head office is located in Singapore.
POEM may be in USA or India depending on other facts.

E. Precautions by Indian Entrepreneurs

- **In case of ABOI**, precautions by Indian entrepreneurs to ensure POEM outside India:-
 - Majority of Board Meetings of the company should be held outside India.
 - Key decisions of the company as a whole should be taken by Board of Directors in the meetings of the Board.
 - No correspondence regarding decisions to be taken at the meeting should be made by Indian owners to the Board.

E. Precautions (Continued)

- **In case of Non-ABOI**, following precautions to be taken for POEM outside India:-
 - Majority of decision makers (directors) to be based outside India.
 - Directors are capable of making decisions and do not appear to be dummies.
 - Decision making process is duly documented in terms of agenda and minutes for every meeting.
 - Records should clearly indicate that the Board has been taking all key management and commercial decisions necessary for conduct of company's business as a whole.

E. Precautions to be taken (Continued)

- Majority of meetings of Board of Directors as well as of all committees (if there are any committees) of Board must be held in the place which is intended to be POEM of the company.
- Senior Management of the foreign company ought to be based at the place which is designated to be head office (or POEM) of the foreign company, being at a place other than India.
- The accounts of the company be kept at the place which is intended to be POEM of the foreign company.

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