

PLACE OF EFFECTIVE MANAGEMENT TEST IN THE INCOME TAX ACT, 1961: IS IT THE RIGHT WAY FORWARD?

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The Finance Act, 2015 amended §6(3)(ii) of the Income Tax Act, 1961 to introduce a new test for determining the residential status of companies. The new test is called the 'Place of Effective Management' test for interpretation of which, the Central Board of Direct Taxes has recently issued draft guidelines. This test replaces the erstwhile control and management test which has common law origins and was laid down in a context that best suited the interests of imperial powers. Looking closely at the workings of the erstwhile test and comparing it with the definition and draft guidelines on the Place of Effective Management test, it emerges that there is much similarity. Further, the government's justifications for making this amendment are on shaky ground which raises some fundamental concerns which need to be addressed first. 'Place of Effective Management' does not have a universally accepted meaning and Organisation for Economic Co-operation and Development which does recognise the concept, has now recommended adopting a case-by-case approach to determine the residential status of companies to tackle tax avoidance. Alignment of the domestic law with the so-called international standard of Place of Effective Management (where it used as a tie-breaker rule in a number of Double Taxation Avoidance Agreements), would only reduce the tie-breaker rule of Place of Effective Management to naught.

I. INTRODUCTION

Most countries tax a person based on the person's residential status or the source of his or her income.¹ The residence and source rules are thus crucial to determine where a person would be liable to pay tax and consequently, his or her ultimate tax exposure.

In the case of an individual, the residence test is usually based on meeting the threshold of a minimum duration of stay in a particular jurisdiction

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¹ ANGHARAD MILLER & LYNNE OATS, PRINCIPLES OF INTERNATIONAL TAXATION 25 (4th ed., 2014).

during the relevant financial year. India follows the same criterion.² In the instance of a company, countries use a number of different approaches, ranging from a legal approach, where the incorporation is used as the basis, to an economic approach, where *inter alia* management or place of primary business location is used as a determining tool.³

India uses a combination of the said two approaches under the Income Tax Act, 1961 ('Act'). A company incorporated in India is considered to be a resident for tax purposes.⁴ The second test,⁵ which uses an economic nexus, is the core subject matter of this paper. The test uses the criterion of 'place of effective management' ('POEM') and comes into effect from the Assessment Year⁶ of 2016-2017. Thus, it applies to transactions being carried out between March 31, 2015 and April 1, 2016 (which is the corresponding Previous Year⁷). Prior to the enactment of POEM, § 6(3)(ii)⁸ of the Act looked at whether a company's control and management ('CM') was situated wholly in India. If so, it qualified to be a resident in India.

As is apparent, the POEM test primarily targets companies that have not been incorporated in India. A foreign company being classified as a resident under the Act would have to pay tax to the Indian government on its total income⁹ irrespective of where the income is sourced/derived from.¹⁰ The tax rate applicable to foreign companies under the Act is 40% or 50% depending on the principles contained therein.¹¹

The government opined that the CM test had been unable to contain the burgeoning problem of shell companies and consequently, tax avoidance.¹² Thus, it became imperative to look for an alternate test. To buttress the POEM test, the government has given two primary justifications. First, it is desirable to use POEM as it is an internationally recognised and well accepted concept, acknowledged also by the Organisation for Economic Co-operation and

² The Income Tax Act, 1961, §6(1) & §6(6).

³ MILLER AND OATS, *supra* note 1, 67.

⁴ The Income Tax Act, 1961, §6(3)(i) read with §2(26).

⁵ The Income Tax Act, 1961, §6(3)(ii) *inserted vide* The Finance Act, 2015 (w.e.f. April 1, 2016).

⁶ The Income Tax Act, 1961, §2(9).

⁷ The Income Tax Act, 1961, §3.

⁸ The Income Tax Act, 1961, §6(3)(ii) (A company is said to be resident in India in any previous year, if during that year, the control and management of its affairs is situated wholly in India).

⁹ Income is defined in §2(24) of the Income Tax Act, 1961. In the case of a resident, total income refers to the sum total of his or her income derived from any source which is received or deemed to be received in India by or on behalf of such person or accrues or arises or is deemed to accrue or arise in India or accrues or arises to him or her outside India. *See generally* The Income Tax Act, 1961, §§7 & 9.

¹⁰ The Income Tax Act, 1961, §5(1).

¹¹ The Income Tax Act, 1961, Schedule I, Part I, ¶E.

¹² Memorandum Explaining the Provisions in the Finance Bill, 2015, 32, available at <http://indiabudget.nic.in/ub2015-16/memo/mem1.pdf> (Last visited on February 18, 2016).

Development ('OECD'). The reference to POEM can be found at Article 4(3)¹³ of OECD's Model Convention with Respect to Taxes on Income and on Capital ('Model Tax Convention'). Second, introduction of POEM would help align the domestic law with that of India's Double Taxation Avoidance Agreements ('DTAAs') where POEM is relied upon as a tie-breaker rule.¹⁴

On December 23, 2015 the Central Board of Direct Taxes has, almost nine months after the POEM test came into effect, published a draft guidance note¹⁵ setting forth the foundational principles for the application and interpretation of POEM ('Guidelines'). Comments to the Guidelines were invited from stakeholders and general public until January 9, 2015. Thus, this is an opportune time to undertake a study of the concept, the Guidelines and the justifications of the government for the amendment.

The brief layout of the paper is as follows: Part II of the paper examines the common law origins of the test and its evolution within India and the United Kingdom ('UK'). This forms the foundation for the critique appearing later in the paper. Part III dwells on deconstructing the POEM test and the Guidelines of the government to assess the scope, efficacy and purpose of the test. Part IV critically analyses the two justifications relating to the concept of POEM given by the government while introducing the amendment. Part V presents the concluding remarks.

II. OVERVIEW OF THE RESIDENCE RULE FOR COMPANIES IN INDIA

In order to critically analyse the POEM test and make an enquiry into whether it improves the erstwhile test, it would be germane to begin the analysis with a brief history of the residential rule for companies in India. Special emphasis is laid on the workings of the CM test that POEM replaces. It is also worthwhile to look at the evolution of the common law test within UK, as it is apparent, as evidenced by the discussion in the latter part of the paper, that the Indian and UK judiciary have been faced with similar challenges when applying the tests and the substance over form approach.

¹³ Organisation for Economic Cooperation and Development, Model Convention With Respect to Taxes on Income and on Capital, Art. 4(3) (Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated).

¹⁴ Memorandum, *supra* note 12.

¹⁵ Ministry of Revenue, Draft Guiding Principles for Determination of Place of Effective Management (POEM) of a Company, F.No.142/11/2015-TPL (Published on December 23, 2015).

The test to determine the residential status of companies was legislatively enacted into the Indian Income Tax Act, 1922.¹⁶ §4A(c)(a) of the Indian Income Tax Act, 1922 makes the first statutory reference to the CM test. Interestingly, there was also another test in §4A(c)(b) which deemed a company resident if its income arising in British India exceeded its income outside of British India for the relevant year. The latter test survived constitutional validity¹⁷ but was omitted by the Finance Act, 1958¹⁸ pursuant to a recommendation by the Law Commission.¹⁹

In *V.V.R.N.M. Subbayya Chettiar v. CIT*,²⁰ the Supreme Court observed that the CM test carries the same meaning as the test of central management and control ('common law test') laid down by the House of Lords in *De Beers Consolidated Mines Ltd. v. Howe*²¹ ('De Beers'). The facts were as follows, De Beers Consolidated Mines Limited had been incorporated in the Colony of the Cape of Good Hope (now part of South Africa) where the actual mining activities were undertaken. On the other hand, the board meetings took place in Kimberley (South Africa) and London. A majority of the directors were residing in London. It was held that in the context of companies, one had to investigate where a company really keeps house and does business or where its central management and control abides.²² The company was considered to be resident in London as all important matters, such as, negotiation of contracts, policy decisions on disposal of diamonds and other assets, application of profits, appointment of directors were taken up there.²³

It is apparent that the *situs* of real business was interpreted neither as the place of the operations nor as where the profit making activities were carried out. It was understood to be the place where the management decisions were made. There appears to be a colonial sub-text to how this test emerged. This can be illustrated through a situation similar to De Beers²⁴ that arose in *Calcutta Jute Mills Co. Ltd. v. Nicholson*.²⁵ India did not charge high taxes from British firms operating in India as the nation was under the British rule. On the other hand, entities based in the colony could still be taxed in UK if shown to be resident under the latter's law.²⁶ Hence, the common law test worked very well

¹⁶ The Indian Income Tax Act, 1922, §4A(c), *inserted vide* The Indian Income Tax (Amendment) Act, 1939.

¹⁷ *Wallace Bros. and Co. Ltd. v. CIT*, (1945) 47 Bom LR 153; ¶9 (per P. Spens, Kt. C.J.).

¹⁸ Finance Act, 1958, §4.

¹⁹ Law Commission of India, Income Tax Act, 1922, Report No. 12, 330, (September 1958), available at <http://lawcommissionofindia.nic.in/1-50/report12.pdf> (Last visited on December 25, 2015).

²⁰ *V.V.R.N.M. Subbayya Chettiar v. CIT*, AIR 1951 SC 101; ¶7 (per Fazl Ali, J.).

²¹ *De Beers Consolidated Mines Ltd. v. Howe*, 1906 AC 455.

²² *Id.*, 458 (per Lord Loreburn L.C.).

²³ *Id.*, 459 (per Lord Loreburn L.C.).

²⁴ *Id.*

²⁵ *Calcutta Jute Mills Co. Ltd. v. Nicholson*, (1876) 1 TC 83.

²⁶ MILLER AND OATS, *supra* note 1, 67-68.

for the imperialist powers as they were able to secure tax revenue on activities carried out in the colonies by ensuring that the companies were managed from their territory. The test has survived nearly a century in the country of its origin and has significantly shaped the way a company has been taxed in other common law countries, for example, Australia²⁷ and Singapore²⁸.

A. THE INDIAN EXPERIENCE WITH THE CM TEST AND ATTENDANT SUBSTANCE OVER FORM APPROACH

Drawing from the common law precedents,²⁹ the CM test has come to be associated in India with an enquiry into the company's controlling and directing power or its head and brain, as opposed to its day-to-day management. The court looks to not where the directors reside but where the board decides the key issues.³⁰ Some examples of key issues are ones relating to company policy, financial matters, disposal of profits and any other significant items concerning the general and corporate affairs of a company.³¹ The reference to the term 'situated' has meant to imply the functioning of the power at a place with some degree of permanence and stability.³²

Unlike the common law test, the CM test required control and management to be situated "wholly in India"³³ during the concerned financial year. The threshold it appears, may have been inspired from *Swedish Central Railway Co. Ltd. v. Thompson*³⁴ which held that it was possible for CM to vest in more than one location. Hence, by corollary if it could be shown that even partial control was exercised from abroad, the company was not an Indian resident.³⁵

The government noted that this loophole rendered the CM test into a mockery as companies were able to avoid becoming a resident by merely convening a single board meeting abroad.³⁶ As aforementioned, this was one of the reasons for which the government chose to substitute the CM test with the POEM test.

²⁷ Income Tax Assessment Act, 1936, §6(1).

²⁸ Income Tax Act (Chapter 134), §2(1).

²⁹ See generally *De Beers Consolidated Mines Ltd. v. Howe*, 1906 AC 455; *Swedish Central Railway Co. Ltd. v. Thompson*, 1925 AC 495 (laying down the foundational principles for the common law test).

³⁰ *Radha Rani Holdings (P) Ltd. v. Director of Income Tax*, (2007) 110 TTJ (Del) 920 ¶5, 17.

³¹ *Saraswati Holding Corpn. Inc. v. Director of Income Tax*, (2007) 111 TTJ (Del) 334, ¶3.5.

³² *K.V. Narasimha Rao Bahadur v. CIT*, AIR 1950 Mad 808, ¶17.

³³ The Income Tax Act, 1961, §6(3)(ii).

³⁴ *Swedish Central Railway Co. Ltd. v. Thompson*, 1925 AC 495.

³⁵ *Supra* note 30, ¶14.

³⁶ Memorandum, *supra* note 12.

The Indian courts have held that the spirit of the analysis is to be one of substance over form³⁷. The underlying principle is that if the board of directors are shown to exercise complete local control, the company qualifies to be a resident.³⁸ Indian courts and tribunals have had the occasion to interpret the CM test in the context of companies in very few instances. Most cases³⁹ have involved partnership firms and Hindu Undivided Families which also use a test⁴⁰ based on CM, albeit with an inverse presumption.

In *Radha Rani Holdings (P) Ltd. v. Director of Income Tax*,⁴¹ the question to be determined was whether a company incorporated in Singapore was controlled and managed from India. The Assessing Officer argued that the CM was exercised in India through Mrs. Geeta Soni who was the majority shareholder and director resident in India. During the concerned financial year, there had been one key board meeting on 18th April, 2001 which considered the issue of granting a loan to a sister concern. The Assessing Office claimed that on such date, Mrs. Soni was not in Singapore where the alleged board meeting was shown to have taken place.

Just because Mrs. Soni was a majority shareholder, CM could not have been ascribed to her. Management lies with the board and each director enjoys equal powers. The second director (Mrs. Juliana Kassim) was a Singapore resident and there had been no proof of her having traveled to India.⁴² The tribunal held that Mrs. Soni's physical presence in Singapore was irrelevant as she could have attended the meeting virtually.⁴³ Hence, the *situs* of the key board meeting was Singapore and the company was a non-resident. Reliance had also been placed on the fact that the company had obtained a tax residency certificate issued by the Singapore taxation authorities.⁴⁴

The investigation by the Assessing Officer had revealed that there had been no operating office in Singapore and that the affairs of the company mostly comprised and related to matters in India like funds, investments and loans.⁴⁵ Hence, in a situation that appears to have warranted substantive analysis the tribunal failed to see whether in fact, each director enjoyed equal powers of management. The substance over form approach although hinted at,⁴⁶

³⁷ B.R. Naik v. CIT, (1945) 13 ITR 124 (Bom); CIT v. Nandlal Gandadal, AIR 1960 SC 1147.

³⁸ Radha Rani Holdings (P) Ltd. v. Director of Income Tax, (2007) 110 TTJ (Del) 920, ¶15.

³⁹ V.V.R.N.M. Subbayya Chettiar v. CIT, AIR 1951 SC 101; CIT v. Nandlal Gandadal, AIR 1960 SC 1147; K.V. Narasimha Rao Bahadur v. CIT, AIR 1950 Mad 808; CIT v. Shanmugham Rubber Estate, AIR 1945 Mad 366; CIT v. Palaniappa Chettiar, (1945) 13 ITR 269 (Mad); CIT v. Gangabishan, (1945) 1 MLJ 61.

⁴⁰ The Income Tax Act, 1961, §6(2).

⁴¹ Radha Rani Holdings (P) Ltd. v. Director of Income Tax, (2007) 110 TTJ (Del) 920 ¶5, ¶17.

⁴² *Supra* note 30, ¶17.

⁴³ *Supra* note 30, ¶18.

⁴⁴ *Supra* note 30, ¶20.

⁴⁵ *Supra* note 30, ¶2, ¶7.

⁴⁶ Radha Rani Holdings (P) Ltd. v. Director of Income Tax, (2007) 110 TTJ (Del) 920, ¶15 (“The head and brain of a company is the board of directors, and if the board of directors exercised

received, at best, mere lip service in this decision. It also seems dubious that weight was placed on the tax residency certificate issued by a foreign authority.

B. EVOLUTION OF THE COMMON LAW TEST AND THE SUBSTANCE OVER FORM APPROACH IN UK

Since its origins in the UK, the common law test has seen application in relatively more complicated scenarios set in parent-subsidiary relationships and involving the role of advisors and promoters. Thus, the substance over form approach has assumed crucial significance in the UK and it is important to see how the courts have applied this principle.

In *Unit Construction Co. Ltd. v. Bullock*⁴⁷ it had been noted that though the subsidiary had independent boards empowered to make decisions under the constitutional documents, due to trading difficulties the board of directors of the subsidiaries had been standing aside. All matters of real importance were in fact being made by the parent company's board.⁴⁸ As the powers of the subsidiary's boards had been usurped, the corporate veil was pierced to reveal that the actual management was in the hands of the parent company's directors.⁴⁹

On the other hand, in *Wood v. Holden*⁵⁰ it was held that the decisions were made through the constitutional organs of the company, albeit under the influence of an outsider/advisor which did not amount to usurpation. Here, the fact that the directors passed the requisite resolutions and that there were good commercial reasons to do so had been held sufficient to demonstrate that independent decision making had transpired.⁵¹ Did the directors have sufficient information to be able to make informed decisions? Her Majesty's Revenue and Customs had argued otherwise. A closer reading would show that the Special Commissioners' inarticulate remarks may have led to the court deciding the instance as one of influence and not usurpation.⁵²

This very question came up for consideration in *Laerstate BV v. Revenue and Customs Commissioners*⁵³. It was held that the place where the board meetings were held or relevant documentation was signed was an insufficient indication. The fact that one of the directors (Mr. Trapman) was not given sufficient documentation showed that he had not been involved in the

complete local control, then the company is also deemed to be resident").

⁴⁷ *Unit Construction Co. Ltd. v. Bullock*, 1960 AC 351 : (1959) 3 WLR 1022 : (1959) 3 All ER 831 (HL).

⁴⁸ *Id.*, 364.

⁴⁹ *Id.*, 374.

⁵⁰ *Wood v. Holden*, (2006) 1 WLR 1393.

⁵¹ *Id.*, 1410-1411.

⁵² Rebecca Murray, *Degree of Influence*, TAX JOURNAL, 996, 15 (2009).

⁵³ *Laerstate BV v. Revenue and Customs Commissioners*, 2009 SFTD 551.

decision making. The First Tier Tribunal assessed that the overall control was in the hands of an individual, Mr. Bock, even after he resigned as a director. As his decisions were made predominantly in the UK, the company was resident in the UK. This decision has achieved finality as no appeal was preferred by the taxpayers.⁵⁴

Pertinently, four scenarios were identified - directors may either (a) sign the documents mindlessly, (b) know what they are signing but may not consider the merits of it or may lack information to take an objective decision, (c) be acting as per the shareholders' wishes but with some absolute minimum information or (d) make an informed decision.⁵⁵

Hence, it would be fair to conclude that even in the UK the substance over form approach is slowly evolving and the courts have had their share of struggles in assessing tricky situations.

III. THE POEM TEST: AMBIT, PURPOSE AND EFFICACY

A. WHAT IS THE POEM TEST?

The POEM test has been defined under §6(3)(ii) of the Act 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.”

This definition mirrors the language in the commentary to Article 4(3)⁵⁶ of the Model Tax Convention, as acknowledged by the government.⁵⁷

Indian legislators have been contemplating the introduction of the POEM test in the Act since 2010, as can be seen in Clauses 4(3)⁵⁸ and 314(192)⁵⁹ of the draft Direct Tax Code Bill, 2010. The definition of POEM was two pronged. In the first instance, it would be the place where the board of directors or executive directors made their decisions. However, if it seemed that the board plays merely the formal role of an approver rather than a decision

⁵⁴ *Id.*, ¶¶ 38-45.

⁵⁵ *Id.*, ¶¶ 34-37.

⁵⁶ *Supra* note 13.

⁵⁷ Memorandum, *supra* note 12.

⁵⁸ Direct Tax Code Bill, 2010, Cl. 4(3) (“A company shall be resident in India in any financial year, if— (a) it is an Indian company; or (b) its place of effective management, at any time in the year, is in India”).

⁵⁹ Direct Tax Code Bill, 2010, Cl. 314(192) (“Place of effective management means (i) the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or (ii) in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions”).

maker, the focus would shift to where the decision makers of commercial and strategic matters (executive directors or officers) performed their functions. The Standing Committee on Finance⁶⁰ felt that terms such as ‘executive directors’ and ‘officers’ should be deleted as it leads to uncertainty. It was suggested that the definition should conform to the international standard contained in the OECD Commentary. This paved the path for adoption of the current definition in § 6(3)(ii) of the Act.

When the Standing Committee on Finance⁶¹ suggested the change in the language for the POEM test, it opined that the test should be re-defined as the place where the key management and commercial decisions as a whole are made *or* where the company’s head and brain is situated. Does this not indicate that the POEM was not understood as being very different from the erstwhile head and brain test? In fact, when the POEM test was suggested as a tie-breaker rule by the Organisation for European Economic Co-operation, the meaning of POEM was considered to be no different from that of the CM/common law test.⁶²

The aforementioned discussion on the POEM test is with respect to the domestic taxation law. However, the POEM test is contained in a number of DTAAAs that India has entered into with other nations, an aspect which is discussed in greater detail in Part IV of the paper.

The Indian courts and tribunals have had occasion to interpret the POEM test, as used in India’s DTAAAs. In *Saraswati Holding Corpn. Inc. v. Director of Income Tax*⁶³ the Tribunal observed that the erstwhile CM test is materially different from POEM.⁶⁴ However, this point was not elaborated any further. Interestingly though, the tribunal’s conclusion that the CM was not in India led to the finding that POEM was also not in India.⁶⁵ Hence, it remains unclear whether courts and tribunals in India also ever considered these two tests as leading to different answers.

B. OVERVIEW OF THE POEM GUIDELINES

The Guidelines, though still awaiting finalisation, provide an insight into how the POEM test is to be understood. The underlying policy as per

⁶⁰ Standing Committee on Finance, Fifteenth Lok Sabha, *Report on The Direct Taxes Code Bill, 2010*, Forty-Ninth Report, ¶1.14-1.15 (March 2012), available at http://itatonline.org/downloads_info.php?varname=dl_id=805&varname2=Download%20Report%20of%20Standing%20Committee%20on%20Direct%20Tax%20Code%20Bill%202010 (Last visited on January 15, 2016).

⁶¹ *Id.*, ¶1.15.

⁶² John F. Avery Jones, *The Definition of Company Residence in early UK Tax Treaties*, 2008 BTR 556, 574-577.

⁶³ *Supra* note 31.

⁶⁴ *Supra* note 31, ¶3.4.

⁶⁵ *Supra* note 31, ¶4.

the Guidelines is to adopt a holistic approach preferring substance over form. The determination of POEM is to be done annually and will depend on the immediate facts and circumstances.⁶⁶

The Guidelines define a new category of companies engaging in “active business outside India” (‘ABOI’). The categorisation is to 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.⁶⁷ Passive income is the aggregate of income from transactions where purchase and sale is from/to its associated enterprises⁶⁸ and income by way of royalty, dividend, capital gains, interest or rental income.⁶⁹

The said quantitative exercise is to be undertaken on an analysis of the average of three years data, including the relevant financial year. On fulfilling the prescribed threshold a company will be presumed to be non-resident as long as majority of its board meetings are held abroad. The presumption may be rebutted if the board does not exercise *de facto* powers of management.⁷⁰

In the case of all companies that are not engaged in ABOI India, there is a two-pronged process. First step is identification of persons who actually make the key management and commercial decisions for conduct of the company’s business as a whole. Second step is ascertaining the *situs* of the actual decision making. The POEM would be the place where the board meets regularly if it does, in substance, make the key management and commercial decisions. If however, it is found that the board 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).⁷¹

The Guidelines define the head office as being the place where the company’s senior management (persons generally responsible for formulating key strategies and policies and for overseeing the implementation) are located.⁷² In cases where the senior management is dispersed, the Guidelines prescribe a set of factors to be considered – location where senior management (a) is primarily or predominantly based, normally return to, following travel or (c) meet when formulating or deciding key strategies and policies for the company as a whole.⁷³

⁶⁶ Guidelines, *supra* note 15, ¶6 & 10.

⁶⁷ Guidelines, *supra* note 15, ¶5(a).

⁶⁸ The Income Tax Act, 1961, §92A.

⁶⁹ Guidelines, *supra* note 15, ¶5(c).

⁷⁰ Guidelines, *supra* note 15, ¶7.

⁷¹ Guidelines, *supra* note 15, ¶2(a)-(c).

⁷² Guidelines, *supra* note 15, ¶5(b).

⁷³ Guidelines, *supra* note 15, ¶2(c).

The Guidelines notably shift the focus from a meaningless search for the physical location of meetings by acknowledging that many meetings nowadays take place virtually.⁷⁴ If all else fails, secondary factors such as place where main and substantial activity takes place or accounting records are kept are to be considered.⁷⁵ The Guidelines clarify that ownership from India, local management in India and undertaking support functions in India do not constitute POEM.⁷⁶

When an assessing officer seeks to hold a foreign company as resident in India he will need the prior approval of the Principal Commissioner or Commissioner who may provide the company an opportunity of being heard before deciding the matter.⁷⁷

C. CRITICAL ANALYSIS OF THE DEFINITION AND GUIDELINES

This section is dedicated to critically analysing the significant points emerging upon a perusal of the Guidelines. It is hoped that these points will be taken into consideration before the Guidelines are firmed up by the Central Board of Direct Taxes.

First, the government admits that the CM test was unsuccessful in containing the problem of tax avoidance on account of the “wholly” threshold in the definition. The POEM definition does not refer to such threshold, which is a positive move. So then, what is the threshold, if any, under the POEM test?

An earlier version of the POEM provision appearing in the Draft Direct Tax Code Bill, 2010 as well as §4(ii)⁷⁸ of the Finance Bill, 2015 had stipulated that a company would be resident in India if its POEM was found to be in India at “at any time” during the relevant financial year. The problem with such an approach would have been just the opposite of using the term “wholly”. If “wholly” in the erstwhile CM test raised the bar really high, the inclusion of “at any time” lowered the threshold excessively⁷⁹ and hence, it is a welcome step that the latter was eventually dropped in the Finance Act, 2015.

⁷⁴ Guidelines, *supra* note 15, ¶8.2(c) & (e).

⁷⁵ Guidelines, *supra* note 15, ¶8.2(f).

⁷⁶ Guidelines, *supra* note 15, ¶9.

⁷⁷ Guidelines, *supra* note 15, ¶11.

⁷⁸ Finance Bill, 2015, §4(ii) (“For clause (3), the following clause shall be substituted with effect from the 1st day of April, 2016, namely:— ‘(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, at any time 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.”).

⁷⁹ NISHITH DESAI ASSOCIATES, DIRECT TAXES CODE GLOBAL THINK TANK 125-6 (2011).

In light of the deletion of “wholly” and “at any time of the year”, it appears that the threshold is set somewhere in the middle. Thus, it may be inferred that while all meetings need not be held in India, merely holding one meeting in India would also be insufficient. This inference is also supported from what appears to be the preferred approach as per the Guidelines which is to identify where effective management is “predominantly”⁸⁰ located, meaning, where a majority of the key decisions were held. The reference to a majoritarian approach can also be seen from the rebuttable presumption⁸¹ made in favor of companies shown to be engaged in ABOI.

Second, the criterion of CM has now been replaced with effective management. Under the POEM definition, in essence the search is for the place where the key management and commercial decisions needed for the running of the entity as a whole are made.⁸² The task is to identify the real decision makers, be it the board, senior management, an executive committee or any other person applying a substantive approach.⁸³ If only local management is conducted from India, it would not lead to a conclusion that POEM is in India.⁸⁴

How different is this from the CM test? Even under the CM test, the enquiry was directed towards identifying the company’s head and brain or the place from where actual decision making occurred.⁸⁵ While expounding on the test, courts had again emphasised on the need to adopt a substantive analysis.⁸⁶ Hence, in principle the CM test and POEM test appear to be similar.

It is submitted that if the substance over form approach had been applied in its true spirit, it cannot be assumed that only the board of directors can constitute a company’s head and brain. Considering how rarely⁸⁷ §6(3)(ii) has been interpreted in the context of companies, it may be fair to say that the judicial and quasi-judicial authorities have not been afforded adequate opportunity to develop the true jurisprudence of the provision.

Having said that, let us hope that with the Guidelines coming into place the right questions are raised and addressed in the future. It is also laudable that the Guidelines, unlike the definition in the Draft Direct Tax Code, 2010, contemplate that the board of directors, executive directors or officers are not the sole repositories of POEM but that it may vest with a holding company, senior management or any other persons including a shareholder.⁸⁸

⁸⁰ Guidelines, *supra* note 15, ¶10.

⁸¹ Guidelines, *supra* note 15, ¶7.

⁸² The Income Tax Act, 1961, §6(3)(ii) *inserted vide* The Finance Act, 2015 (w.e.f. April 1, 2016); Guidelines, *supra* note 15, ¶2.

⁸³ Guidelines, *supra* note 15, ¶¶ 8.1-8.2.

⁸⁴ Guidelines, *supra* note 15, ¶ 9.

⁸⁵ *Supra* note 30, ¶¶5, 17.

⁸⁶ B.R. Naik v. CIT, (1945) 13 ITR 124 (Bom); CIT v. Nandlal Gandlal, AIR 1960 SC 1147.

⁸⁷ *Supra* note 30.

⁸⁸ Guidelines, *supra* note 15, ¶5(b), 5(d), 7.1 & 8.2.

One of the important phrases that the Guidelines has left undefined is “key management and commercial decisions...necessary for conduct of entity as a whole”⁸⁹. The Guidelines juxtapose decision making covered within the POEM test from local management to exclude the latter. The entire guidance on locating effective management will be in vain if we do not know which kind of decisions are covered by the POEM test. The lack of clarity is exacerbated by the inconsistent language used in the Guidelines. While para 2 of the Guidelines uses the terms “key management and commercial decisions”, para 5(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”.

In the absence of adequate guidance, what if reliance were to be placed on earlier precedents interpreting CM to understand the ambit of the POEM test?

Third, the guidelines seek to identify a new category of companies; those engaging in ABOI⁹⁰. The categorisation will be based on adducing proof on criteria, as outlined above. If a company fulfils this test, a rebuttable presumption of it being a non-resident will be made in its favor as long as majority of its board meetings are held abroad.

These criteria are set in quantitative terms which make it potentially, easy to work around. Before the introduction of POEM, theoretically speaking, every foreign company was subject to the CM test and attendant substantive analysis. However, now only a sub-set of foreign companies (which do not satisfy the ABOI test) will be subject to such analysis. Additionally, the definition of passive income targets trading and manufacturing companies⁹¹ but leaves out other kinds of activities/companies, such as inter-group transactions involving rendering of services.

The passive income language is reminiscent of the test in §4A(c) (b) of The Income Tax Act, 1922 (discussed earlier) which looked at the proportion of a company’s income from within British India to that earned without British India. The rationale for this language seems to be to build a stronger economic nexus within the POEM test and to tackle tax avoidance. However, by making blanket assumptions that income of a certain nature is passive, without looking at the specifics involved, makes the attempt counter-productive as it may cover instances which do not necessarily include any avoidance of tax.

⁸⁹ Guidelines, *supra* note 15, ¶2.

⁹⁰ Guidelines, *supra* note 15, ¶5(a).

⁹¹ Sachin Dave, *Indian Companies with Foreign Units likely to be impacted by POEM*, THE ECONOMIC TIMES, December 29, 2015. http://articles.economictimes.indiatimes.com/2015-12-29/news/69379545_1_pwc-india-double-taxation-us-subsidiary. (Last visited on February 18, 2016).

Hence, it appears doubtful that this is the best way of going about tackling tax avoidance.

Also, the said quantitative exercise is to be undertaken on an analysis of the average of three years data, including the concerned financial year.⁹² The Guidelines operates retrospectively, to such extent. While the power to impose retrospectivity in taxation statutes has been upheld,⁹³ it is subject to a caveat that such legislation should not be unreasonable.⁹⁴ As the Guidelines have been notified almost at the end of this financial year it appears as though a last minute surprise is bring sprung upon companies which makes the measure look unreasonable. Considering the widespread criticism against the retrospective amendments introduced through Finance Act, 2012 to undo the ruling in *Vodafone International Holdings BV v. Union of India*,⁹⁵ the government may benefit from reconsidering this measure.

Fourth, the Guidelines make contrary statements at paras 6 and 10 with respect to whether a company can have more than one center of POEM.

The OECD Commentary notes that there may be more than one place of management but only one POEM.⁹⁶ This statement befits the international set-up as the POEM test in treaties is meant to act as a tie-breaker rule.⁹⁷ However, at the domestic level, it is conceivable that owing to differing domestic law interpretations, POEM may occur in more than one country. This is the precise reason for having a tie-breaker rule in the DTAA's, in the first place. Hence, caution must be exercised while importing language from the OECD Commentary into the domestic law.

Fifth, the Guidelines acknowledge that most meetings nowadays take place virtually allowing for parties from multiple locations to participate in the process. Hence, the Guidelines impress upon the need to not go after a

⁹² Guidelines, *supra* note 15, ¶7.2.

⁹³ *Ujagar Prints (2) v. Union of India*, (1989) 3 SCC 488, ¶25.

⁹⁴ EXPERT COMMITTEE, Draft Report on Retrospective Amendments Relating to Indirect Transfer (2012).

⁹⁵ *Holdings BV v. Union of India*, (2012) 6 SCC 613.

⁹⁶ Commentary to the Model Tax Convention, ¶24, available at http://www.keepeek.com/Digital-Asset-Management/oced/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en#page93 (Last visited on January 26, 2016).

⁹⁷ Agreement between the Government of The Republic of India and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Australia and India), December 30, 1991, Art. 4(3); Agreement for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Mauritius (Mauritius and India), December 6, 1983, Art. 4(3); Double Taxation Avoidance Agreement between the Government of The Republic of India and the Government of the Russian Federation for the Avoidance of Double Taxation with respect to Taxes on Income (Russian Federation and India), April 11, 1998, Art. 4(3); Agreement between the Government of The Republic of India and the Government of the United Arab Emirates for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital (United Arab Emirates and India), September 22, 1993, Art. 4(3).

meaningless search for the physical location of a meeting. However, while doing so, there is some inconsistency. When dealing with senior management's virtual participation, the Guidelines say that the POEM would be the location of the highest level of management.⁹⁸ However, the Guidelines go on to state at para 8.2(e) that the place of residence of the decision makers may also be a relevant factor. The approach to be adopted must be clarified.

Sixth, as per the Finance Act, 2015 the POEM test applies to companies for the Previous Year beginning April 1, 2015. The Guidelines however, are still awaiting finalisation. It is thus advisable that the effective date of the test be made applicable only once the final Guidelines have been published.

IV. ANALYSING THE GOVERNMENT'S JUSTIFICATIONS FOR THE SWITCH TO POEM

A. IS POEM AN INTERNATIONALLY RECOGNISED AND WELL ACCEPTED CONCEPT?

The government has claimed that POEM is an internationally recognised concept, accepted by OECD and used by India in a number of its DTAAAs. Moreover, it is a “well accepted concept” and there are “well recognised guiding principles” to understand the contours of the POEM test.⁹⁹ The government's justification seems to give the impression that the use of the POEM test internationally accords it normative status. Further, the second statement may suggest that the concept of POEM has a universally accepted meaning. However, each of these inferences is far from true. Moreover, even if it were to be assumed that the POEM test is internationally accepted, it is still not clear why it is appropriate to be imported into Indian domestic law.

It is true that the reference to the POEM test can be found in Article 4(3)¹⁰⁰ of OECD's Model Tax Convention. It is also found in a number of DTAAAs¹⁰¹ that India has negotiated with other countries. To provide a brief background, DTAAAs are bilaterally negotiated treaties with a view to avoid instances of double taxation and prevent fiscal evasion. If both countries that are signatories to a treaty simultaneously classify a company as a resident in their respective jurisdiction, POEM comes to the rescue as a tie-breaker rule.

However, the provisions of OECD's Model Tax Convention are not binding. Moreover, it has been shown through empirical evidence that

⁹⁸ Guidelines, *supra* note 15, ¶8.2(c).

⁹⁹ Memorandum, *supra* note 12.

¹⁰⁰ *Supra* note 13.

¹⁰¹ *Supra* note 97.

the provisions of the Model Tax Convention favor the interests of developed countries.¹⁰²

Now, to look at the meaning attributed to the concept of POEM. Article 4(3) of the Model Tax Convention does not define POEM. The prevalent meaning of the POEM test comes from the Commentary to Article 4(3) of the Model Tax Convention. The Commentary goes on to note that some countries prefer to use the case-by-case method to resolve conflicts on residential status or to determine the meaning of place of effective management.¹⁰³ Also, some countries¹⁰⁴ have made express reservations to the use of the POEM test as a tie-breaker rule. The lack of a universally accepted meaning of the POEM test may be on account of different corporate structures in common law and civil law systems.¹⁰⁵

Looking to the Indian practice, the POEM test has not been defined in any of the DTAAs where it finds a mention. In a number of treaties¹⁰⁶ that incorporate the POEM test, the competent authorities are called upon to settle by mutual agreement its meaning when found indeterminable. Also, few treaties¹⁰⁷ do not incorporate the POEM test.

¹⁰² See Alberto Vega García and Ilja Rudyk, *Explaining Reservations to the OECD Model Tax Convention: An Empirical Approach*, In Dret - Revista para el análisis del derecho (Special II AEDE Conference), (4), 1-19 (2011).

¹⁰³ Commentary to the Model Tax Convention, ¶24, available at http://www.keepeek.com/Digital-Asset-Management/oced/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en#page92 (Last visited on January 26, 2016).

¹⁰⁴ Commentary on Article 4 to the Model Tax Convention, ¶¶28-34, available at http://www.keepeek.com/Digital-Asset-Management/oced/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en#page94 (Last visited on January 26, 2016).

¹⁰⁵ John F. Avery Jones, et al., *The Origins of Concepts and Expressions used in the OECD Model and their Adoption by States*, [2006] BTR, 695 at 720.

¹⁰⁶ Convention between the Government of The Republic of India and the Government of the Republic of Armenia for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income (Armenia and India), September 9, 2004, Art. 4(3); Convention between the Government of The Republic of India and the Government of Canada for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital (Canada and India), May 6, 1997, Art. 4(3); Convention between the Government of The Republic of India and the Government of Ireland for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains (Ireland and India), December 26, 2001, Art. 4(3).

¹⁰⁷ Convention between the Government of The United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income (United States of America and India), December 18, 1990, Art. 4(3); Agreement between the Government of The Republic of India and the Government of Canada for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital (Canada and India), May 6, 1997, Art. 4(3); Agreement between the Government of The Republic of India and the Government of The People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (China and India), November 21, 1994, Art. 4(3).

More recently, as part of OECD's efforts to tackle Base Erosion and Profit Shifting, it has been suggested that the reference to POEM in the Commentary to Article 4(3) should be dropped. Any conflicting claims of residential status should be left to mutual agreement and in such analysis POEM may be one of the factors considered.¹⁰⁸ The reason for the suggested change was the view of many countries that instances of dual residence involve tax avoidance which would be better resolved on a case-by-case basis.¹⁰⁹

In light of the above, this justification alone does not appear to hold much weight in supporting the government's amendment.

B. IS IT DESIRABLE TO ALIGN THE DOMESTIC AND INTERNATIONAL TESTS?

The second justification of the government is that the amendment would help align the test used in our domestic tax law with that in our DTAAAs. The statement of the government leads us to believe that POEM is universally used in all of our DTAAAs. However, as has been pointed out, a number of DTAAAs¹¹⁰ that India has signed do not mention the POEM test.

While it is apparent that the government intends to use the same test domestically and internationally, does this also imply that the meaning attributable to POEM at the domestic level and international level is to be identical?

The government's justification is based on the assumption that mirroring the international test at the domestic level is desirable. There is a fundamental flaw with the government's rationale.

As mentioned above, POEM is used in a number of treaties to resolve issues pertaining to residential status precisely when a company is classified as resident in more than one country, simultaneously. If each country were to follow suit and adopt the POEM test domestically and internationally, it would lead to an anomalous situation. To illustrate my point, take the case of two countries A and B, both of which use POEM in their domestic law as well as in their DTAAAs. Having said that, ideally, use of the same test domestically

¹⁰⁸ OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report*, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page74, paras 47-48 (Last visited on January 18, 2016).

¹⁰⁹ OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report*, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page74, ¶47 (Last visited on January 18, 2016).

¹¹⁰ *Supra* note 107.

should give the same answer but owing to the controversy around the meaning of POEM there could be a potential dual residency claim. In such situation, resorting to POEM again as a tie-breaker rule is likely to give no easy resolution. The tie-breaker rule must be based on a distinct criterion, for example, place of substantial activity or day to day management.

The next logical question to be pondered upon is to what extent this alignment exercise is to be undertaken; must the domestic jurisprudence on POEM also inform the understanding of the tie-breaker rule? India had made a reservation to Article 4(3) of the Model Tax Convention stating that it would also take into account the place where an entity carries out its main and substantial activity.¹¹¹ This reservation has now been deleted but the Guidelines include the factor of activity as a secondary factor¹¹². Does this mean that the deletion of India's reservation stands nullified now? Once the Guidelines are finalised, will India be precluded from making a contrary reservation or argument in interpreting the tie-breaker rule?

V. CONCLUSION

The traditional understanding has been that the CM test and POEM test are similar. A perusal of the Guidelines reinforces such impression as both tests are based on the same fundamental premise. Hence, it appears that we may not have moved away from the colonial CM test. As has been highlighted, there are loopholes even within the Guidelines which may be manipulated to gain tax arbitrage. If so, will the POEM test be able to tackle the problem of tax avoidance and shell companies? The jury is still out on the same. The avowed objective of introducing POEM is definitely worth commendation. Now that the Guidelines explicitly contain the substance over form approach, we may hope for better enforcement by authorities and adherence by companies.

However, there are even more fundamental questions begging for an answer here. POEM has not been attributed a universally accepted meaning and even the OECD has now been recommending a case-by-case approach. The goal of aligning the domestic law and international law tests appears misguided as it may render the role of POEM as a tie-breaker rule redundant. The policy makers ought to clarify the *inter se* relationship between POEM as a domestic law test and a tie-breaker rule before our domestic law compromises our interests in the international context of making and negotiating DTAA's.

¹¹¹ Organisation for Economic Cooperation and Development ('OECD'), *The 2008 Update to the OECD Model Tax Convention*, 112, July 18, 2008 available at <http://www.oecd.org/ctp/41032078.pdf> (Last visited on January 27, 2016).

¹¹² Guidelines, *supra* note 15, ¶8.2(f).