

Place of Effective Management

FIT Jubilee Conference
December 4, 2015

Panel:

Mr V. Lakshmikumar, India (*Chairman*)

Shefali Goradia, India (*Panel leader*)

Michael Lang, Austria

Pragya Saksena, India

Daksha Baxi, India

Mahesh Kumar, Singapore

Nilesh Kapadia, India

POEM – Definition

- A foreign company shall be said to be resident in India in any previous year, if its place of effective management, **in that year**, is in India
- “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

Extract from the Memorandum

“.....'Place of effective management' (POEM) is an **internationally recognized concept for determination of residence of a company incorporated in a foreign jurisdiction.** Most of the tax treaties entered into by India recognize the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. Many countries prefer the POEM test to be appropriate test for determination of residence of a company. The principle of POEM is recognized and accepted by Organization of Economic Cooperation and Development (OECD) also. The OECD commentary on model convention provides definition of place of effective management to mean 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. The modification in the condition of residence in respect of company by including the concept of effective management would **align the provisions of the Act with the Double Taxation Avoidance Agreements (DTAAs)** entered into by India with other countries and would also be in line with international standards.....”

Determination of POEM – Issues

Term	Particulars
Key management and commercial decisions	<ul style="list-style-type: none">➤ Which decisions should be considered?<ul style="list-style-type: none">▪ Top level management – decisions taken by the Board; or▪ Middle level management eg division heads; or▪ Day to day functioning of the business
Conduct of the business	<ul style="list-style-type: none">➤ Which activities need to be considered?<ul style="list-style-type: none">▪ Only the main activities; or▪ Also ancillary activities➤ Whether only income generating activities should be considered?➤ Whether non-core activities should also be considered (eg treasury, legal and financing activities)?

Determination of POEM – Issues

Term	Particulars
In substance made	➤ Substance over form approach
In that year	<ul style="list-style-type: none">➤ during the whole of the year; or➤ at any time of the year – one Board meeting held in India; or➤ during a reasonable period of time during the year – what should be a reasonable period of time?
Entity as a whole	➤ Key decisions for the entire company or key decisions for individual divisions of the company should be considered?

BEPS – Action Plan 6

47. The 2008 Update to the OECD Model Tax Convention introduced an alternative version of Article 4(3) (see paragraphs 24 and 24.1 of the Commentary on Article 4) according to which the competent authorities of the Contracting States shall, having regard to a number of relevant factors, endeavour to determine by mutual agreement the State of which the person is a resident for the purposes of the Convention. When that alternative was discussed, the view of many countries was that cases where a company is a dual resident often involve tax avoidance arrangements. For that reason, the current rule found in Article 4(3) should be replaced by the alternative found in the Commentary, which allows a case-by-case solution of these cases.

48. The following are the changes that will be made to the OECD Model Tax Convention in order to implement that decision

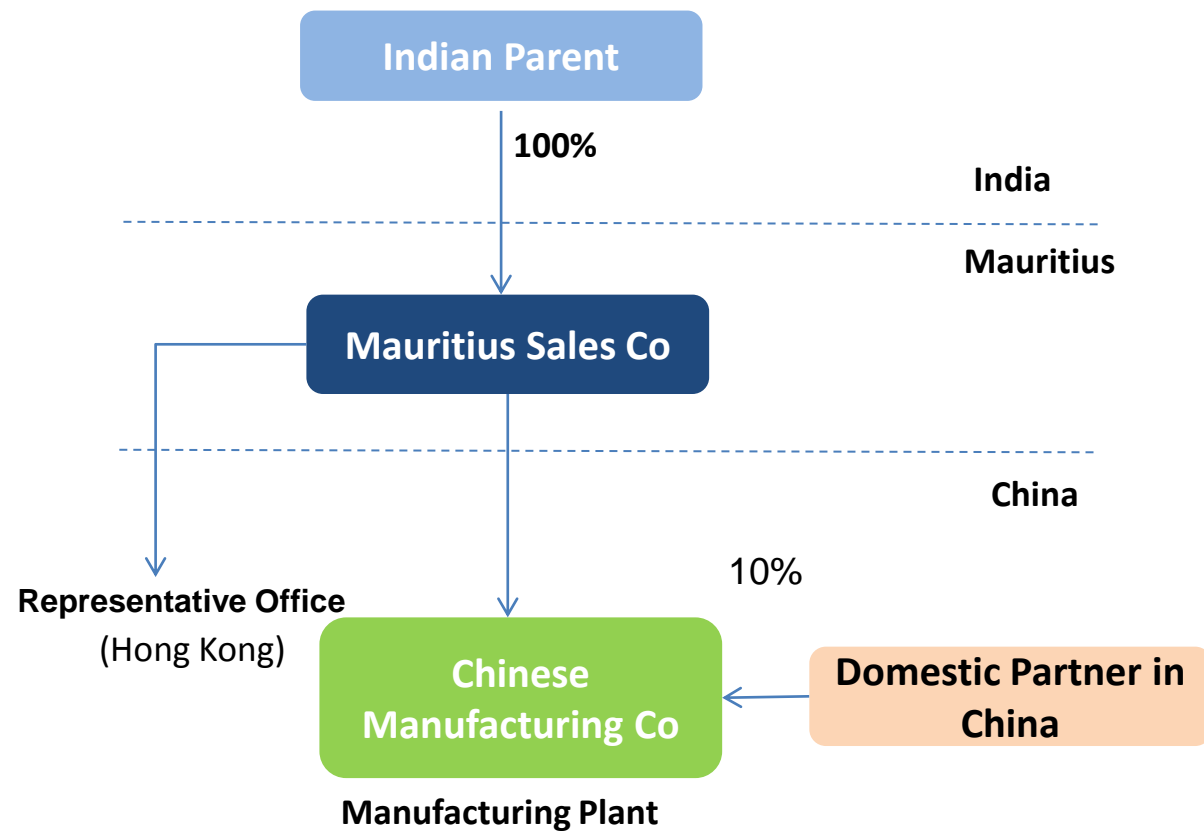
BEPS – Action Plan 6

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. The competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States

Dual Resident Companies

- Tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals
 - MAP: incorporation, “otherwise constituted”, “any other relevant factor
 - Absence of general MAP: individual MAP
- Consequences:
 - Making treaty shopping more difficult
 - Goes beyond: not proportionate?

Case Study



Facts

- Indian Parent has a wholly owned subsidiary in Mauritius, M Co. In turn M Co owns 90% of the Chinese subsidiary, Chinese Manufacturing Co (CM Co)
- Indian Parent is engaged in the business of manufacture and sale of a variety of machinery
- M Co is a trading company (not a GBL 1 & hence not eligible to treaty benefits)
- CM Co has a manufacturing plant in China
- The core business functions undertaken by each entity are summarised in following slides

Core Business Functions of CM Co

- Admin & management of the plant carried out by employee of M Co, stationed in China
- Operations, logistics, accounting functions undertaken by the team employed by CM Co, located in China
- While capex plan discussed with Indian Parent, the maintenance etc decisions undertaken by the team of CM Co
- Almost entire production of CM Co sold to M Co, who in turn sold to customers in India as well as outside India.
- Indian parent acts as selling agent of M Co in India
- Pricing of products determined by Indian Parent
- Out of 5 members of the board of CM Co, 2 Indian residents, 2 Chinese residents and 1 HK resident; Chairman of Board – Indian resident and visits China several times
- Indian Parent's employees visit China for inspection of products and for identifying raw materials for use in manufacturing activities of CM Co

Core Business Functions of M Co

- Its business is to purchase all the produce of CM Co and sell the same to customers in India and/ or other parts of the world
- Has an administrator in Mauritius but no other employee based in Mauritius. A few employees are posted to CM Co
- Indian Parent does all the correspondence for M Co including raising the bills etc.
- Accounts are prepared by Indian Parent, though audit is undertaken by Mauritius auditor.
- The profit margin to be added to the products sold by M Co (for the sale of products purchased from C M Co) is decided by the Indian Parent
- Only one Mauritius Director. One Indian resident director and 2 non- Indian, non Mauritius directors

Tax Issues

- Will the subsidiaries be regarded to be resident in India?
- Will they be dual residents? How will the double taxation be resolved?
- What will be the rate of tax applicable – 30 % / 40 %?
- Will subsidiaries be considered to have a place of business in India for levy of MAT?
- Will the persons making payment to such companies be exempt from WHT obligations under S. 195?
- Will the transactions between related parties fall within TP regime?
- Applicability of GAAR?
- Will they be subject to DDT upon distribution of dividend and subject to additional tax upon buy-back of shares? (applies to 'domestic' co so this should be less of an issue?)
- If POEM is in India, is determination of PE still relevant?

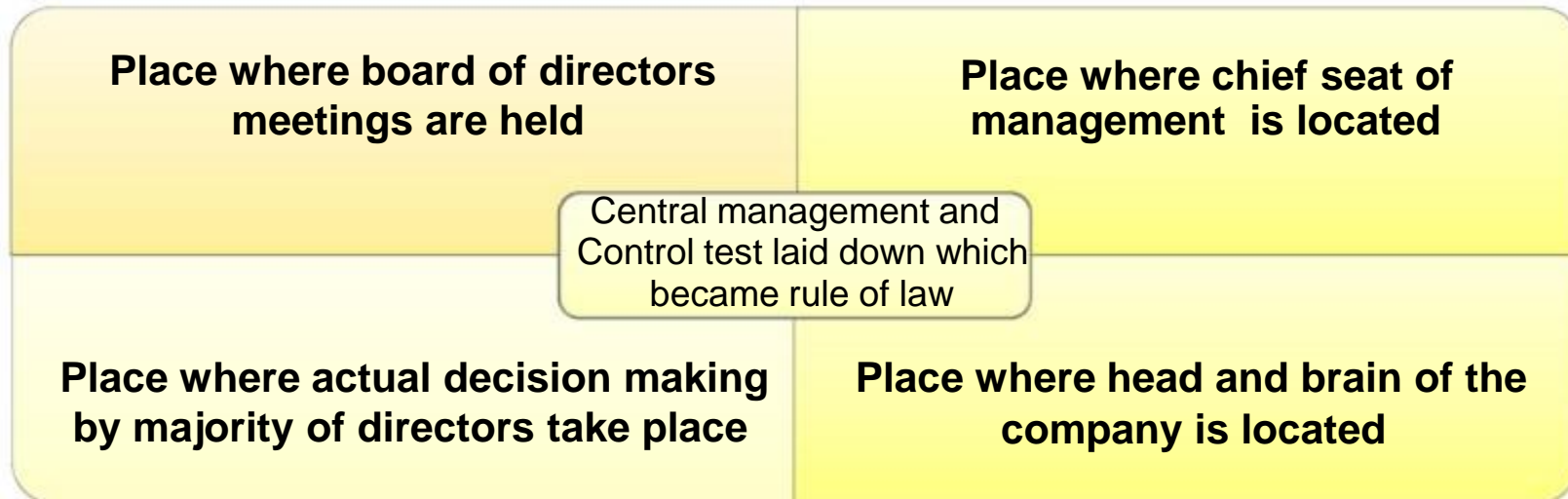
POEM – International Jurisprudence

De Beers Consolidated Mines Ltd v Howe (5 TC 198) 1905

Particulars	London	Kimberley
Country of Incorporation - owned mines and mining property	-	√
Ordinary directors	9	7
Life Governors	2	1
Meetings held weekly	√	√

Powers of BOD in London	Powers of BOD in Kimberley
<ul style="list-style-type: none"> - Negotiation of the contracts with the Diamond Syndicates - Advise directors in Kimberley on matters of exceptional importance - Policy in respect of disposal of diamonds and other assets - Policy in respect of working and development of mines and output of diamonds - Policy in respect of application of profits and appointment of directors - Appointment of directors - BOD meetings to arrive at absolute majority for decision-making purposes 	<ul style="list-style-type: none"> - Determine the course of business in respect of mining diamonds

De Beers Consolidated Mines Ltd v Howe (5 TC 198) 1905



“A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business.’

“The decision of Kelly C.B. and Huddleston B. in the Calcutta Jute Mills v. Nicholson and the Cesena Sulphur Co. v. Nicholson, now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. **I regard that as the true rule, and the real business is carried on where the central management and control actually abides”**

Smallwood Revenue and Customs (SpCc 669) (2008)

“Effective” in POEM should be understood in the sense of French effective which connotes real
[French is another official version of OECD model]

First time in *Wensleydale's Settlement Trustees* ‘ case Special Commissioner David Shirley said of POEM to mean:

*"I emphasise the adjective 'effective'. In my opinion it is not sufficient that some sort of management was carried on in the Republic of Ireland such as operating a bank account in the name of the trustees. **'Effective' implies realistic, positive management.** The place of effective management is **where the shots are called**, to adopt a vivid transatlantic colloquialism."*

Key principles emerging from other decisions

– relevant for subsidiaries

Bullock v Unit Construction Company (38 TC 738)

- While certain operational decisions have been made at a subsidiary level, the directors of the UK parent company had always made key decisions in respect of the three subsidiaries.
- It was thus held that the subsidiaries were UK residents.

Egyptian Delta Land & Investment co. Ltd v Todd (14 TC 119)

- If a company has no place of trade in the UK and does nothing at its head office except for minimum and occasional formalities, it cannot be a resident there. The company therefore held to be resident in Egypt. Court emphasised that the place of incorporation alone would be inadequate to conclude on the residency of a taxpayer.

American Thread company v Joyce (6 TC 1/163)

- Control of the management of the affairs of the American Company vested in UK given that strategic decisions were made at a UK level and that the American Company's board was constantly dominated by the English Company.

POEM – International judicial precedents







Case	Held
Hoge raad der netherlands (Netherlands SC)	<ul style="list-style-type: none">• The term “effective management” is related to taking core decisions, directing, and taking initiatives, rather than carrying out, or preparing or determining, policy, or determining the company's activities.• As daily management seems in opposition to key management, it is unlikely that it could ever make up part of any core decisions.
Case 2C 1086/2012,2C 1087/2012 (Switzerland SC)	<ul style="list-style-type: none">• POEM must be distinguished from both top-level management activities and purely administrative activities.• POEM defines as the economic and effective center of a company.• The decisive factor is the management of daily business activities within the company's purpose.
Yanko weis Holdings Ltd v. Holon income tax Assessor (Israel district court)	<ul style="list-style-type: none">• POEM should be determined on the basis of a factual assessment of where the decisions as to the company's business policies, strategy and daily decisions were taken• Place where the management decisions were actually taken instead of execution the same.

Questions in Indian context




- Will India use the above parameters for determination?
- Will all of them need to be considered or only some?
- Which factors are more relevant than the others?
- What about preparatory and auxiliary activities?
- Will this determination be eligible for MAP proceedings?

Annexure: Residency Rules Internationally

Residency Rules - interpretation of POEM

<p>Australia</p> 	<p>A company becomes a resident of Australia if it is incorporated in Australia or if it carries on business in Australia, and has either its central management and control in Australia or its voting power is controlled by shareholders who are residents of Australia</p>
<p>Belgium</p> 	<p>Belgian tax law defines POEM as the place where the actual key decisions controlling the company are taken, disregarding the location where the BOD formally approve decisions taken elsewhere</p>
<p>France</p> 	<p>France has interpreted the OECD commentary for the determination of POEM as place where the person or the group of persons exercising the most senior functions makes its decision</p>
<p>Greece</p> 	<p>POEM is the place where the day-to-day management of the company takes place, where the strategic business decisions are made, where the key meetings take place, where the accounting books are kept or if the BOD comprises of Greek residents. The tax administration may also examine additional factors</p>
<p>Hungary</p> 	<p>POEM is the place where the key management and commercial decisions are made, where the top executives are located and where the senior executives carry on day to day management of the enterprise</p>
<p>Italy</p> 	<p>Italian tax laws determine POEM as the place where the main and substantial activity of the entity is carried on. However, the courts consider POEM as the place where key decisions are actually taken, irrespective of the place where they are formally made</p>

Residency Rules - Interpretation of POEM

<p>Netherlands</p> 	<p>Domestic tax law considers POM where the place of ultimate managerial responsibilities over the place where day-to-day management is effected</p>
<p>Russia</p> 	<p>A foreign company is deemed to be a resident in Russia if a relative majority of board meetings are held in Russia, if executive body regularly conducts company related activities from Russia or if the Chief executives perform their managerial duties from Russia. Tax administrations may consider other criteria such as place of maintenance of accounting records, place from which HR functions are undertaken, etc</p>
<p>USA</p> 	<p>US follows the OECD commentary for the determination of POEM. However, it reserves the right to use a place of incorporation test for the determination of tax residency of a corporation</p>

Each contracting state adopts different criteria for determining the POEM