



## The CBDT issues draft guiding principles for determination of the Place of Effective Management of a company

### Background

The Finance Act, 2015 amended<sup>1</sup> the provisions of Section 6(3) of the Income-tax Act, 1961 (the Act) to provide that a company is said to be resident in India in any previous year, if it is an Indian company or its Place of Effective Management (POEM) in that year is in India. POEM 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.

POEM is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognise the concept of POEM for determination of the residence of a company as a tie-breaker rule for the avoidance of double taxation.

The memorandum explaining the provisions of the Finance Bill, 2015 stated that a set of guiding principles to be followed in the determination of POEM would be issued for the benefit of taxpayers as well as the tax administration.

### Draft guiding principles

The Central Board of Direct Taxes (CBDT) has issued draft guiding principles for the determination of POEM of a company. The draft guiding principles are summarised as follows:

#### ***Active business outside India***

An entity may have more than one place of management, but it can have only one POEM at any point of time. Since 'residence' is to be determined for each year, POEM will also be required to be determined on a year to year basis. The process of determination of POEM would primarily be based on the fact as to whether or not the company is engaged in active business outside India.

A company shall be said to be engaged in 'active business outside India' if its passive income<sup>2</sup> is not more than 50 per cent of its total income, and:

- Less than 50 per cent of its total assets are situated in India; and
- Less than 50 per cent of its total number of employees are situated in India or are resident in India; and

<sup>1</sup> With effect from Assessment Year 2016-17

<sup>2</sup> 'Passive income' of a company shall be the total of (a) income from the transactions where both the purchase and sale of goods is from/to its Associated Enterprises (AEs) and (b) income by way of royalty, dividend, capital gains, interest or rental income.

- The payroll expenses incurred on such employees is less than 50 per cent of its total payroll expenditure.

The POEM in the case of a company engaged in active business outside India shall be presumed to be outside India if the majority of the meetings of the board of directors of the company are held outside India. However, if on the basis of facts and circumstances it is established that the board of directors of the company are standing aside and not exercising their powers of management and such powers are being exercised either by the holding company or any other person(s) resident in India, then the POEM shall be considered to be in India.

For the purpose of determining whether the company is engaged in active business outside India, an average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such a period shall be considered.

In cases of companies other than those which are engaged in active business outside India, the determination of POEM would be a two stage process i.e.:

- Identifying or ascertaining the person(s) who actually take the key management and commercial decisions for the conduct of the company's business as a whole.
- Determining the place where these decisions are being made.

### **Location criteria**

The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM, it is the substance which would be conclusive rather than the form.

Some of the guiding principles which may be taken into account for determining the POEM are as follows:

- The location where a company's board regularly meets and makes decisions, may be the company's POEM, provided the board:
  - Retains and exercises its authority to govern the company; and
  - In substance, makes the key management and commercial decisions necessary for the conduct of the company's business as a whole.

The mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held, then such other place would be relevant for POEM. As an example, this may be the case where the board meetings are held in a location distinct from the place where the head office<sup>3</sup> of the company is located or wherein such a location is unconnected with the place where the predominant activity of the company is being carried out.

### **Delegation of authority**

If a board has de facto delegated the authority to make the key management and commercial decisions for the company to the senior management<sup>4</sup> or any other person including a shareholder and does nothing more than routinely ratifying the decisions that have been made, the company's POEM will ordinarily be the place where these senior managers or the other person makes those decisions.

<sup>3</sup> 'Head office' of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.

<sup>4</sup> 'Senior Management' in respect of a company means the person(s) who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and an ongoing basis. These persons may include:

- Managing Director or Chief Executive Officer
- Financial Director or Chief Financial Officer
- Chief Operating Officer, and
- The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members from the senior management. In such situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for mere formal approval by the full board will often be considered to be the company's POEM.

The delegation of authority may be either *de jure* (by means of a formal resolution or the Shareholder Agreement) or *de facto* (based upon the actual conduct of the board and the executive committee).

### **Location of the head office**

The location of a company's head office will be a very important factor in the determination of the company's POEM because it often represents the place where key company decisions are made.

The following points need to be considered for determining the location of the head office of the company:

- If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters, then that location is the place where the head office is located.
- If the company is more decentralised, then the company's head office would be the location where these senior managers
  - are primarily or predominantly based; or
  - normally return to after travelling to other locations; or
  - meet when formulating or deciding key strategies and policies for the company as a whole.

Members of the senior management may operate from different locations on a more or less permanent basis and may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situations, the head office would normally be the location, if any, where the highest level of management and their direct support staff are located.

In situations where the senior management is so decentralised that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's POEM.

### **Modern technology impact on POEM**

The use of modern technology impacts POEM in many ways. It is no longer necessary for the persons taking decisions to be physically present at a particular location. Therefore, physical location of the board meeting, executive committee meeting or meeting of the senior management may not be where the key decisions are in the substance being made. In such a case, the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.

If the above factors do not lead to clear identification of a POEM, then the following secondary factors can be considered:

- Place where the main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

### **Other guiding principles**

It has been clarified that the day to day routine operational decisions undertaken by junior and middle level management shall not be relevant for the purpose of determination of POEM.

The determination of POEM is to be based on all relevant facts related to the management and control of the company and is not to be determined on the basis of isolated facts that by itself do not establish effective management. The illustrative examples of POEM are as follows:

- The fact that a foreign company is completely owned by an Indian company will not serve as conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- The fact that one or more of the directors of a foreign company reside in India will not serve as conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- The fact that the local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, serve as conclusive evidence that the conditions for establishing POEM have been satisfied.
- The existence of support functions in India that are preparatory and auxiliary in nature, will not serve as conclusive evidence that the conditions for establishing POEM in India have been satisfied.

Based on the facts and circumstances, if it is determined that during the previous year the POEM is in India as well as outside India, then the POEM shall be presumed to be in India if it has been mainly/predominantly in India.

### ***Procedural aspects***

The draft principles for determining POEM are for guidance only. No single principle will be decisive in itself. The draft principles are not to be seen with reference to any particular moment in time; rather the activities performed over a period of time, during the previous year, need to be considered.

The draft principles provides that in case the Assessing Officer (AO) proposes to hold a company incorporated outside India, on the basis of its POEM, as being resident in India, then any such finding shall be given by the AO after seeking a prior approval of the Principal Commissioner or the Commissioner. The Principal Commissioner or the Commissioner shall provide an opportunity of being heard to the company before deciding on the matter.

### ***Comments/suggestions invited***

Comments/suggestions on this draft guidance are sought from the stakeholders as well as the general public, and are to be submitted by 2 January 2016 by email address (dirtpl1@nic.in) or by post<sup>5</sup> with 'Comments on draft guidance on POEM' stated on the envelop.

### **Our comments**

The draft guidelines are primarily based on the fact as to whether or not the company is engaged in 'active business outside India'. For determination of 'Active business outside India' factors such as passive income, total asset base, the number of employees, payroll expenses in India and outside, etc. are considered.

The draft guidelines state that the concept of POEM is one of substance over form. It further state that the POEM in the case of a company engaged in active business outside India shall be presumed to be outside India, if the majority of the meetings of the board of directors of the company are held outside India. The guidelines also deal with the impact of modern technology in POEM determination.

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The AO would require to seek prior approval of the Principal Commissioner or the Commissioner to hold a company incorporated outside India as being resident in India on the basis of POEM.

Since this development will have far reaching impact on taxpayers, the government should consider the comments/suggestions given by various stakeholders before the release of the final guidelines.



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