

# HACspeak

## *Taxability of foreign companies in India*

### *Determination of Place of Effective Management*

*Amendment in law and the Draft guidelines issued by the Central Board of Direct Taxes*

1. In the case of a non-resident foreign company the scope of total income that is taxable in India is defined in section 5(2) of the Indian Income Tax Act, 1961 ['Act']. Accordingly a non-resident company's income is taxable in India to the extent such income is received/deemed to be received in India or accrues/arises or is deemed to accrue/arise in India in such year.
2. Section 6(3) of the Act defines the circumstances in which a company would be resident in India.
3. Finance Act, 2015 has amended section 6(3) of the Act which would impact the taxability of foreign companies in India.
4. Prior to the amendment of 2015 a foreign company was considered as a resident in India
  - a. if it was either a Indian company (i.e. a company incorporated under the Indian Companies Act), or,
  - b. Even though it was a foreign company, if during that year, the control and management of it's affairs was wholly situated in India.

Thus a company incorporated under the Indian Companies Act, 1956 or Companies Act, 2013 was (and even after the amendment) continues to be a resident in India in all circumstances. However, prior to the amendment, a foreign domiciled company was regarded as a company resident in India provided it's control and management was wholly situated in India.

5. Post amendment to the definition u/s 6(3) the residential status of a company in India shall depend upon the basis of 'Place of Effective Management' ['PoEM']. PoEM is an internationally recognised concept 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 residence of a company as a tie-breaker rule for avoidance of double taxation.

6. In light of the above, the provisions of section 6(3) of the Act have been amended with effect from assessment year 2016-17, to provide that a company is said to be resident in India in any previous year, if
  - a. It is an Indian company; or
  - b. Its place of effective management in that year is in India.

The term 'Place of Effective Management' has been defined by insertion of an Explanation to section 6(3), which provides that *'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.*

7. For this, CBDT has issued the Draft Guidelines which seek to provide guidance on determination of PoEM so as to determine the residential status of foreign companies in India.

- 7.1. The Draft Guidelines begin with an emphasis on the fact that the concept of PoEM is one of substance over form and that its determination is fact driven. Determination of PoEM is to be done on a year to year basis. Also, such determination would primarily be based on whether or not the company is engaged in *'active business outside India'*.

- 7.2. Companies having active business outside India

Certain terms, including *'active business outside India'*, are defined in the guidelines as follows:

- a. A company shall be said to be engaged in *'active business outside India'* if-
    - its passive income is not more than 50% of its total income; and
    - less than 50% of its total assets are situated in India; and
    - less than 50% of the total number of employees are situated in India or are resident in India; and
    - the payroll expenses incurred on such employees are less than 50% of its total payroll expenses.
  - b. 'Passive Income' of a company shall be aggregate of –
    - Income from the transactions where both the purchase and sale of goods is from/to its associated enterprises; and
    - Income by way of royalty, dividend, capital gains, interest or rental income

For determining whether the company is engaged in active business outside India, the average of data of the previous year and two years prior to that shall be taken into account.

- 7.3. Determination of PoEM will depend upon the facts and circumstances of any given case. An entity may have more than one place of management, but at any point of time, it can have only one place of effective management. Since residential status of a company is to be determined for each year, determination of PoEM will require determination on a yearly basis.

The draft guidelines provide four circumstances which shall govern the fact whether or not PoEM is in India, viz:

- a. a company is engaged in *active business outside India*.
  - b. companies *other than those having active business outside India*,
  - c. general principles governing PoEM
  - d. in the absence of clear identification, the secondary factors to be taken into account
- 7.4. PoEM in case of a company which is engaged in *active business outside India*,
- a. its PoEM shall be presumed to be outside India, provided the majority meetings of its Board of Directors are held outside India.
  - b. However, if on facts it is established that the power to manage is not being exercised by the Board, but is being exercised by the holding company or any other person(s) resident in India, PoEM shall be considered to be in India.
- 7.5. In case of companies other than those having active business outside India, determination of PoEM would be a two-stage process
- a. Stage I – identification or ascertaining persons who actually make the key management and commercial decisions for the conduct of the company's business as a whole
  - b. Stage II – determination of the place where these decisions are in fact being made.
- 7.6. There are certain general principles which are provided for in the Draft Guidelines which may be taken into account for determination of PoEM:
- a. The place where management decisions are taken would be more important than the place where such decisions are implemented.
  - b. The place where the Board regularly meets and makes decisions provided the Board retains and exercises its authority to govern the company and in substance makes the key management and commercial decisions necessary for conduct of the company's business as a whole.

- c. 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. Mere formal holding of Board meetings at a place would by itself not be conclusive for determination of PoEM.
  - d. If the Board *de facto* delegated the authority to make the key management and commercial decisions to the senior management or any other person (including a shareholder), and itself only ratifies the decisions that have been made, PoEM will be the place where such senior management or any other person make those decisions.
  - e. If the authority has been delegated by the Board to any committee, then the location of the members of the committee and where the committee develops and formulates the key strategies and policies for mere approval by the full board will often considered to be the company's PoEM.
  - f. The location of a company's head office will be an important factor in the determination of the company's PoEM as it represents the place where key decisions are made. The location of senior management and their support staff and the location that is held out to the public as company's principal place of business, etc. can be considered to determine the location of head office.
  - g. If the members of senior management participate in a meeting via telephone or video-conferencing rather than by being physically present at meeting in a particular location, then in such a situation, the head office would normally be the location, if any, where the highest level of management and their direct support staff are located and so determined head office would be considered for determination of PoEM
  - h. Day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of PoEM.
  - i. Residence of the directors or the persons taking the decisions or place where majority of them usually reside may also be a relevant factor in determination of PoEM in case persons taking the decisions are not physically present at a particular location.
- 7.7. In case the above guidelines do not lead to a clear identification of PoEM, then the following secondary factors can be considered:
- a. Place where main and substantial activity of the company is carried out;  
or
  - b. Place where the accounting records of the company are kept.
- 7.8. The draft guidelines also provide that the determination of the PoEM shall not be governed by following instances considered in isolation:
- a. Complete ownership of a foreign company by an Indian entity
  - b. One or more directors of a foreign company being resident in India
  - c. Local management being situated in India

- d. Existence in India of support functions which are preparatory and auxiliary in character

It has been reiterated that the above principles for determination of PoEM are for guidance only. Determination of PoEM is not to be based on any individual fact but on all the relevant factors related to the management and control of the company.

- 7.9. If in any case, based on facts and circumstance of the case, if it is determined that during the previous year, the PoEM is in India and also outside India, then PoEM shall be presumed to be in India if it has been mainly or predominantly in India.
  - 7.10. Safeguards – prior approval of Commissioner and opportunity of hearing to the assessee is necessary – The draft guidelines also provide that if the Assessing Officer, on the basis of its PoEM, proposes to hold a company incorporated outside India as being resident in India, then prior approval of the Principal Commissioner or the Commissioner, as the case may be, will be required, who shall provide the assessee with an opportunity of being heard before deciding the matter.
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