

Tax residency of companies

New rule leaves room for discretion in determining whether a foreign company can be said to be resident in India

The Finance Act, 2015, has introduced a new concept for determining scope of taxation for foreign companies in India. Until the change, a foreign company was considered as a tax resident if its entire control and management resided in India. With the change, it will be considered to be tax resident, and subject to tax on its global income if its “ place of effective management” (POEM) is in India.

The POEM concept is mostly found in tax treaties and domestic laws of OECD members, and has been borrowed by the Indian legislature primarily to dilute the test described above. It is aimed at fundamentally altering the test for Indian residents who have companies outside India which in effect are being controlled and managed from India.

The new rule is different from the concept of a controlled foreign corporation (“ CFC”), envisaged under the draft Direct Taxes Code, which taxes passive income of foreign companies, controlled more than fifty percent by residents of foreign jurisdiction.

While India has shied away from the CFC rule, the new tax residency criteria could be even harsh to levy tax on global income of such foreign companies.

POEM is essentially a substance test and has been defined to mean a place where key management and commercial decisions necessary for the conduct of the business as a whole are, in substance made. The OECD principles regard such a place to be where decision makers or such (for example a board of directors) take decisions, the place where the actions to be taken by the enterprise as a whole are determined.

At the same time, the OECD realises that no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. In its view, an enterprise may have more than one place of management, but it can have only one place of effective management at any given point in time.

The new rule leaves several unanswered questions and room for discretion to determine whether a foreign company can be said to be resident in India.

Typically, POEM exist in a place where the board of directors of a company take their decisions. Where would this place be in a world where directors dial into such meetings or conduct proceedings using other tools of communication? Would it be the place where such meetings are chaired from? If yes, what about situations in a digital economy whereby a “ chairless” meeting is held via video conference with participation from different geographies? In an era where conduct of business via digital technologies, the concept of physical presence seems to have little relevance and such identification to a geography would become complex. A traditional

interpretation could possibly create multiple POEMs in different jurisdictions, involving a complicated web of treaty interpretations besides economic double taxation.

A distinction needs to be made between shareholder rights and management decisions.

Enough room for doubt is created in situations where shareholders exercise affirmative rights to protect their investment in an offshore company as compared to situations where shareholders take effective decisions with stamp of foreign board.

Substance and capability of aboard to take decisions may become a moot question to determine tax residency status of such foreign companies in India.

A foreign company being brought to tax in India under POEM would be taxed at a rate as high as 40%, considering the rate applicable to domestic resident companies is 30%. Subsequently, when income is distributed to the Indian shareholders, there is another level of tax of 30 per cent on such dividends. The new law warrants separate provisions to cater to and provide for a taxation regime for such foreign companies under POEM.

Typically, tie breaker rule in tax treaties provides for a POEM test to determine tax residency in the event that both the countries consider it to be resident in their respective jurisdictions. In that situation, the competent authorities of the respective states would be required to resolve the dispute through the mutual agreement procedure. The BEPS Action Plan 6 on Treaty Abuse advocates use of 'primary place of management and control' in place of the POEM. This term has been defined to include the place where senior management exercises day to day responsibility extensively for strategic, financial and operational decisions.

The OECD emphasis in its Action Plan seems to shift from the POEM concept to management of day- to- day operations by both the senior management and support staff. The fate of the ambitious BEPS project would determine whether India would follow suit and re- write its residency laws all over again.

Ambiguities make one wonder whether the government may have better achieved its purpose of taxing outbound "paper" companies through a robust CFC law rather than re- inventing its residency tests. I wonder if an exercise was undertaken to analyse the revenue implications or what was the extent of tax leakage. While the new law brings fresh issues to address, the government needs to supplement it with a succinct and clear promised guidance note to avoid a spate of disputes.

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