

# ANALYSIS OF CONCEPT OF ‘PLACE OF EFFECTIVE MANAGEMENT’ IN INDIA

AUTHOR :[JHEEL GUPTA](#)

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## ANALYSIS OF THE CONCEPT OF ‘PLACE OF EFFECTIVE MANAGEMENT’ IN INDIA[\[1\]](#)

### INTRODUCTION

Section 6 of the Income Tax Act of India principally deals with the conditions in which a business or an individual’s residence is determined if the concerned has a domicile in India. Section 6(3) of the Income Tax Act 1961, which discusses the elements that must be met for a corporation to be determined as a resident of India in the preceding year, places great stress on the idea of Place of Effective Management. Now, there are two significant phases to the notion of ‘POEM,’ namely, before and after the revision of the Finance Act, 2015. Previously, a company’s residential status was assumed to be Indian if it was either an Indian company or engaged in controlling and managing its affairs entirely in India. However, the modification introduced the idea of the Place of Effective Management, with the rule 6(3) being altered to state that a corporation is resident in India if it is either an Indian company or has its place of effective management in India. When it was characterized as a place where good management and commercial decisions are made while providing a fairly broad scope for the same, the term ‘POEM’ was used rather loosely. The ‘POEM’ principle is crucial in determining the residential status of a foreign firm operating in India. The key research issue that encouraged me to concentrate on this topic is the ambiguous definition of ‘POEM.’

In order to evaluate the essence of the provision as a whole, I will also analyse relevant case law linked with the aforementioned principle. This research is important because the ‘POEM’ amendment has a catastrophic impact on the companies that will be formed, especially in the era of globalization and startups all over the world. Such a loose definition or ambiguous nature of such an important principle would lead to several tax disputes and ‘POEM’ related litigations in India.

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## WHAT IS CONCEPT OF ‘POEM’?

Under Section 6(3)(ii) of the Act, the ‘POEM’ test is defined as the location where “important management and commercial decisions that are necessary for the conduct of an entity’s business as a whole are, in substance made.”

The government acknowledges that this definition matches the terminology in the commentary to Article 4(3) of the Model Tax Convention. Since 2010, Indian legislators have considered including the ‘POEM’ criteria in the Act, as evidenced by Clauses 4(3)[\[2\]](#) and 314(192)[\[3\]](#) of the draught Direct Tax Code Bill, 2010. The term ‘POEM’ had two definitions. It would be the location where the board of directors or executive directors made their choices in the first instance. If, on the other hand, the board appears to be only a formal approver rather than a decision maker, the focus will shift to where the commercial and strategic decision makers (executive directors or officers) fulfil their duties.

The Standing Committee on Finance believes that terminology like “executive directors” and “officers” should be removed since they cause confusion. It was suggested that the definition be consistent with the international standard set forth in the OECD Commentary. This opened the way for the current definition in Section 6(3)(ii) of the Act to be adopted.

When the Standing Committee on Finance[\[4\]](#) proposed changing the language for the ‘POEM’ test, it suggested that the test be re-defined as the location where critical management and commercial decisions are made as a whole, or the location of the company’s head and brain. Isn’t this an indication that the ‘POEM’ was not recognized as a distinct entity from the previous head and brain test? In fact, when the Organization for European Economic Co-operation proposed the ‘POEM’ test as a tie-breaker criterion, the meaning of ‘POEM’ was thought to be identical to that of the CM/common law test.[\[5\]](#)

The ‘POEM’ test, as applied in India’s DTAAs, has been the subject of interpretation by Indian courts and tribunals. The Tribunal found that the former CM criteria is fundamentally different from ‘POEM’ in *Saraswati Holding Corp. Inc. v. Director of Income Tax*[\[6\]](#). This point, however, was not further developed. The tribunal’s decision that the CM was not in India, however, led to the judgement that ‘POEM’ was not in India as well. <sup>65</sup> As a result, it’s unknown whether Indian courts and tribunals have ever viewed these two tests as yielding different results.

## **EVOLUTION OF CONCEPT OF ‘POEM’**

A firm was said to be resident in India prior to the amendment of section 6(3) of the Income Tax Act, 1961, if: (a) it was an Indian company, or (b) the control and management of its business was located entirely in India during the preceding year. A corporation was a nonresident company if: (a) it was not an Indian company, and (b) the control and administration of its business were located entirely or substantially outside of India. The word ‘control and management’ was taken as a central controlling power rather than the company’s day-to-day operations. Because the board of directors has central controlling power, the location of board meetings was a determining element in defining the company’s ‘control and management.’ If a foreign company’s Board of Directors meets in India, it is considered a resident in India. The location of shareholders’ or their meetings was deemed irrelevant in defining ‘control and management,’ despite the fact that they are the ultimate owners, because control and management is vested in the Board of Directors.[\[7\]](#)

The Direct Tax Code re-examined the principles governing a company’s residential status.[\[8\]](#) The Direct Tax Code proposed that a firm be considered Indian if it was either an Indian corporation or had its location of effective management in India at any time during the year. As a result, the Direct Tax Code aimed to move the attention away from a foreign company’s “control and management” and toward its “place of effective management.” This was the first time in India that the concept of a “place of successful management” was

recognized.

In its forty-ninth report on the Direct Tax Code bill, the Parliamentary Standing Committee on Finance said that the definition of location of effective management was vague and left space for uncertainty. It was advised that a foreign company's residential status be determined using internationally acknowledged criteria and judicially established principles, with a focus on the location of important management and commercial decisions as a whole, or the location of the company's "head and brain." [\[9\]](#)

Whatever the case may be, the Direct Tax Code has been retired, and the required changes have been made to the Income Tax Act of 1961. [\[10\]](#) Section 6(3) of the Income Tax Act of 1961 was changed by the Finance Act of 2015.

As a result, the idea of 'control and management,' which determined a foreign company's residency status, has been abolished. The Act now recognizes the 'place of effective management' as a criterion in evaluating a foreign company's residency status.

"Place of effective management," according to the explanation attached to the revised section 6(3) of the Income Tax Act of 1961, "means a place where key management and commercial decisions that are necessary for the running of the business of an organisation as a whole are in substance made." However, this explanation does not provide a definitive definition of 'site of effective management.'

The former definition of 'control and management' had become impracticable, according to the explanatory notes to the provisions of the Finance Act, 2015 [\[11\]](#), because a corporation could easily avoid becoming a resident by simply attending a board meeting outside India. This could make it easier to set up shell corporations that are formed outside of India but controlled from there. The 'place of effective management' is justified in the explanatory notes because it is a globally recognised notion.

It further notes that most of India's tax treaties recognise the idea of 'place of effective management' for determining a company's domicile as a tie-breaker rule for avoiding double taxation. However, it just repeats the phrasing of the explanation linked to section 6(3) and does not provide a definitive definition of this term.

The Central Board of Direct Taxes framed draught guiding principles for determining a company's place of effective management in response to the need to explain the concept of 'place of effective management' and in accordance with the statement made in the explanatory memorandum to the Finance Bill, 2015. The document containing the draught guiding principles was made available to the public for feedback and ideas. [\[12\]](#)

## **CONCEPT OF RESIDENTIALITY AND 'POEM'**

It is crucial to remember that in most countries, taxation is imposed on an individual based on his or her residence status or the source of his or her income, so it is necessary to research these factors before determining the amount of tax that will be levied. While there are numerous techniques to defining an individual's residential status in a country, India prefers to employ an economic and administrative approach to do so. That is, it considers the place of incorporation or management of a business as a criterion for determining the taxation scheme. A company incorporated in India will be deemed a resident of India, and will be subject to taxation.

## **POSITION PRIOR TO FINANCE ACT OF 2015**

A firm was assumed to be a resident of India prior to the adoption of the Finance Act 2015 if it was formed in India or if its control and management were based entirely in India. While the first criterion is undisputed, as it is

more or less an open fact that an incorporated company falls within the scope of Indian Resident, it is critical to note that Control and Management is the one that must be given due consideration, as it is a loosely defined term with a very limited scope in its practical application. It was held in the case of *VVR.N.V. Subbaya Chettiar v. CIT*<sup>[13]</sup>, relying on the case of *De Beers Consolidated Mines*<sup>[14]</sup>, where it was inadvertently held that The site where the most important managerial decisions are taken, rather than the location of operations or profit-making activities, determines a country's residency.

While such a concept is undeniable, it is vital to highlight that the use of the phrase "wholly in India" negates the significance of such a provision while opening the door to a slew of concerns that led to the necessity to change it. To begin with, the clause required that the corporate entity's complete control and management be located in India. As a result of this provision, corporations that are entitled to pay taxes in India can now avoid paying them by relocating all of their control and management activities outside of the country. These activities include significant board meetings that serve as the primary source of control and managerial decisions to be held outside of India, as a consequence of which the concerned corporation avoids paying taxes in India and avoiding the company's residential status.



The problem is that such a provision also implies the formation of multiple "Shell Companies." Shell companies are businesses that exist only on paper, with no assets, obligations, or operations, but have a legal entity as a company with no economic activity. This also gives it the appearance of a fictitious corporation. The biggest problem with shell businesses is that they can hide an owner's identity. Taxation can be avoided by placing expensive assets over these shell businesses and selling them. Shell businesses can also be used to launder money around the world. Illegal funds can be moved through a series of shell companies before being legalized as various investments, assets, bonds, and other financial instruments. Such shell firms make it simpler for individuals to escape taxes and avoid paying money to anyone, which has a significant negative impact on the Indian economy.

Now, the rule stipulates that commercial and managerial decisions must be made within India as a whole, making it a requirement that even one commercial or managerial decision made outside of India renders the organization ineligible to become a resident of India. This is a significant benefit because the shell businesses that are formed can escape tax liabilities and their operations can be managed successfully from outside India. In the instance of *Radha Rani Holdings v. ACIT*<sup>[15]</sup>, this was demonstrated.

Another reason for the creation of the concept of ‘POEM’ could be that it was widely recognised around the world, and the existence of gaps in local law demanded an update to one that complied to International Standards.

## **AFTER THE INTRODUCTION OF FINANCE ACT OF 2015**

Companies that were previously considered residents of India because their control and management affairs were carried out entirely in India will now be considered residents of India if and only if it is determined that India is the company’s effective management location, as a result of the introduction of the Finance Act of 2015. It’s crucial to note that, at first glance, such a provision appears to have been drafted haphazardly because “at any moment” would bring the principle of “POEM” into play even if the corporation in question does not fall within the scope of such a construction. In brief, even if a single business meeting were to be held in India for various reasons, the company would be subject to such a tax under the Indian Income Tax Act, which saw a severe need for change in the construction.

In any case, if the company is registered under the Companies Act, 2013, it will not be subject to the concept of the Place of Effective Management because such a registration would inadvertently mean that the company is a resident of India, and even if the ‘POEM’ is invoked, such an incorporation would result in the company’s place of effective management being based in India. We can conclude that ‘POEM’ is the sole essence of the aforementioned requirement after reading both phrases in conjunction with the aforesaid logic.

The Place of Effective Management of a corporation must be identified because the residential status is the one that determines whether or not the company’s revenue is taxable in India. It’s also worth noting that if a foreign company’s ‘POEM’ is created in India, the company’s global income will be recognized as taxable under the Indian Tax Regime.

While the clause solely refers to company’s residential statutes, the percentage of tax that must be paid is determined by whether the company is Indian company (domestic) or not. This clause just assists us in determining whether a tax burden can be imposed on the aforementioned entity.

In order to assess the ‘POEM,’ it is important to remember that any company with a turnover of less than 50 crores would not be covered by this principle, as stated by CBDT [Circular 8/2017](#).

## **ANALYSIS OF CONCEPT OF ‘POEM’**

The first and most important point to note is the removal of the terms “wholly” and “at any time of the year,” which effectively removes the factor that sets the ‘POEM’ threshold, which was well established previously, despite the previous definition’s flaws in construction. This leads to two main dead ends in which it is impossible to quantify how many times every year the idea of ‘POEM’ would be invoked in relation to the requirements of the act. Should meetings constantly be held in India to invoke the notion, or will even one meeting constitute such an ambit for the corporation to fall within such an ambit, is a subject that continues to be debated. Although the preferred site for effective management is taken into account, it is important to remember that this does not always imply that the ‘POEM’ is in that area. This is only a hypothesis that may or may not be correct in all cases, and such an assumption can be described as majoritarian in character, while the introduction of the notion of ABOI goes on to demonstrate the validity of such an approach.

Second, it is critical to mention that the notion tries to examine the location where successful management is observed and important decisions pertaining to the business entity’s operation are made. I’d want to clarify that

the major crux of identifying such a site of effective management should be to find the area where effective decisions are made, which should not, however, be subject to the sort of authority that makes the decision. A casual examination of the clause and the guidelines reveals that such effective management is unintentionally confined to the company's Senior Officials (either the Board of Directors or a single individual), thereby removing Junior Officials from decision-making. The concept of 'POEM' will not apply to that company if the identical managerial decision are made by the company's local management in India because the decisions are not made by the company's senior management. In light of the foregoing basic analysis, I believe that such a construction brings the 'POEM' principle closer to the previously existing Commercial and Management decision provision. Furthermore, using the legislation's substance over form approach, it's crucial to remark that the idea that only senior management will be able to make business decisions is defective and ironic in its actual sense, and, in fact, it contradicts the rule's core goal by plainly breaching its essence.

Furthermore, neither the provision nor the recommendations inadvertently specify how the idea of 'POEM' applies to what types of judgments are covered. When we look at the rules themselves, we notice that the terms "important management and commercial decisions," "key strategies and policies," and "essential corporate decisions" are all used frequently. The guidelines have failed to specify how exactly these fall under the same ambit and to what extent does an activity fall under the scope of the aforementioned terms, let alone whether it is necessary for an activity carried out by a company to fall under the purview of one of these actions or should it fall under the purview of all three, which creates a great deal of ambiguity. The establishment of ABOI firms exacerbates the situation because it will be assumed that it is a non-resident of India if it can demonstrate on paper that the majority of its decisions were made outside of India. When we look at the practical implementation of such a structure, we notice that the notion of 'POEM' will only be applicable to a few international firms, while the remainder will use the concept of ABOI as their defence. When it comes to the idea of ABOI, the passive income that is examined is limited to the manufacturing or trading industries, with the service sector being excluded.

In basic terms, this is limited to manufacturing and trade enterprises, while the others are ignored and will not meet the requirements of an ABOI, which is a huge disadvantage when considering the consequences. Furthermore, because the data is from the previous three years, the guidelines that are being evaluated must be applied retrospectively. It is not an issue to apply the same in a retrospective fashion. Furthermore, it is important to note that the guidelines are released near the end of the financial year, which comes as a shock to the businesses.

Furthermore, based on the facts of the Radha Rani Holdings case and the fact that the 'POEM' will be the location of the highest level of management, it is critical to note that even if the Decision maker attends the meeting virtually, the location of the meeting cannot be determined to be negligible, owing to the fact that such a construction would render the entire purpose of the 'POEM' vague. At the end of the day, nothing has been proposed to identify how precisely the 'POEM' can be determined in such a situation, which would have been preferable to substantiate.

## CONCLUSION

The concept of 'POEM,' while well-intentioned, suffers from a number of problems relating to the issues described above, and my only advice is to establish rules to address the problems. It is critical to recognise that the current system can be exploited, and that it can sometimes impose an unfair liability on a corporation that does not need to be an Indian Resident. In its practical application, it is critical to use a content over form approach to determining such a notion, because it is indisputable that the practical applicability always differs from that entrenched in the laws. Not to mention that the concept of 'POEM' begs for a widely approved

judgement, which has yet to be made, leaving it open to a variety of interpretations. The fundamental question is whether the notion of ‘POEM’ will be able to address the problem of Shell firms in India. In the current situation, it will be unable to address the problem, and while it allows the formation of shell companies due to the aforementioned loopholes, it also imposes an excessive liability on organizations that do not need to be included in the ‘POEM’ method.

[1] Jheel Gupta, National Law University Odisha

[2] Direct Tax Code Bill, 2010, Cl. 4(3)

[3] Direct Tax Code Bill, 2010, Cl. 314(192)

[4] Standing Committee on Finance, Fifteenth Lok Sabha, *Report on The Direct Taxes Code Bill*, 2010, Forty-Ninth Report, 1.14-1.15 (March 2012),

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

[6] (2007) 111 TTJ Delhi 334

[7] *Radha Rani Holdings Pvt. Ltd. v. ADIT*, (2007) 16 SOT 495 (Del)

[8] Direct Tax Code, clause 4.

[9] Parliamentary Standing Committee on Finance (2011-12), *Forty-Ninth Report on Direct Tax Code Bill*, p. 68.

[10] Section 6(3), Income Tax Act, 1961.

[11] Central Board of Direct Taxes, [\*\*Circular No. 19/2015, dated 27 November 2015.\*\*](#)

[12] Central Board of Direct Taxes, Circular No. 142/11/2015-TPL, dated 23 December 2015.

[13] AIR 1951 SC 101

[14] 1906 AC 455

[15] [2007] 110 TTJ Delhi 920