

Is reciting a PoEM that easy

Background

With increased use of technology and globalisation, business management practices have become more smarter. A global head of business can now attend board meetings virtually and participate/conclude strategic decision making. Such transformative approach of conducting business has its own set of challenges including establishing the tax residential status of multinational corporations.

Internationally, the concept of Place of Effective Management ('PoEM') is deep rooted to check such business management practices. Similarly, the Indian Income Tax Act, 1961 ('Act') has included the provisions of PoEM to examine the residential status of non-residents. Most of the tax treaties entered by India recognise the PoEM concept as a tie-breaker rule for avoidance of double taxation.

As per Section 6(1)(3) of the Act, a company is said to be a resident in India in any previous year, if it is an Indian company or its PoEM is in India in that year. Under the Act, PoEM has been defined to mean "a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made."

It is worth noting that the meaning of the terms- 'key', 'management & commercial' has not been defined in Act. Thus, whether a decision of selection of suppliers for a trading company or an allocation of employees on various projects for a payroll company, constitute a key commercial decision or not is a matter of interpretation. Having said that, the definition of PoEM emphasizes on 'substance over form', therefore, while the on-paper position might be different, the actual conduct is relevant for determination of PoEM.

Apropos, we have discussed below the guidelines issued by the Central Board of Direct Taxes ('CBDT') for providing clarity on determining PoEM of non-residents.

Key Aspects as laid by various CBDT Circulars ('PoEM Guidelines')

The Act and the corresponding Income Tax Rules, 1962 ('Tax Rules') do not provide guiding principles for determination of PoEM. Hence, the CBDT vide Circulars¹ has provided clarifications for determination of PoEM in India of a Non-Resident Company. Key aspects for determination of PoEM are summarized below:

- Determined on a year-on-year basis.

¹ Circular Nos. 06 of 2017 dated January 24, 2017, No. 08 of 2017 dated February 23, 2017 and No. 25 of 2017 dated October 23, 2017.

- Reference to guidelines whether the company is engaged in Active Business Outside India ('ABOI').
- Two-stage tests involving
 - determining the people who make key management and commercial decisions, and
 - location of such people, where active business is in India.
- The activities performed over a period of time during the previous year, need to be considered and not at any particular moment.
- If PoEM of non-residents is in India as well as outside India, then PoEM shall be presumed to be in India if it has been predominantly in India.
- PoEM provisions do not apply to companies having gross receipts/ turnover of less than INR 50 crores in a financial year.
- Oversight activities of employees working from India operating for group companies may not constitute PoEM if the activities are restricted to pay roll functions, accounting, HR functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures.

ABOI Test

Vide CBDT guidelines on PoEM, following are the tests to determine ABOI of a non-resident:

A company is said to be engaged in ABOI if it fulfils the cumulative conditions of:

- Its passive income \leq 50% of total income from the transactions, and
- In respect of each of the following,
 - Assets situated in India $<$ 50% of total assets; and
 - Employees situated in India; or are resident in India $<$ 50% of total number of employees; and
 - Payroll expenses incurred on such employees $<$ 50% of its total payroll expenditure

Passive income of a company has been defined as an aggregate of -

- income from the transactions where both the purchase and sale of goods is from/to its Associated Enterprises (AEs), and
- income by way of royalty, dividend, capital gains, interest or rental income.

Having discussed the key aspects of the various CBDT Circulars discussing the guiding principles along with the ABOI test, we have enlisted below the practical challenges in determination of PoEM and w.r.t. the ABOI test.

Practical Challenges:

1. Which conversion rate to be applied on the

- Total turnover for determining applicability of PoEM
- Passive income, assets, payroll expense for conducting ABOI test

As no conversion rate is specified in the Act, Tax Rules or in PoEM guidelines, reference may be drawn to Rule 115 of the Tax Rules which gives the rate of exchange for conversion of income expressed in foreign currency into rupees. While, turnover, passive income and payroll expenditures may still be converted at the year-end rate, however, for conversion of assets, there remains ambiguity.

Here, the Income Computation and Disclosure Standard VI (ICDS - VI) which deals with treatment of transactions in foreign currency can be referred. It categorizes assets into monetary (items where money held and assets to be received or liabilities to be paid are in fixed or determinable amounts of money) and non-monetary items (items other than monetary items). As per the same, while foreign currency monetary items shall be converted into reporting currency by applying the closing rate, non-monetary items in a foreign currency shall be converted into reporting currency by using the exchange rate at the date of the transaction. Thus, assets may be converted using the exchange rate at the date of the transaction.

2. Turnover for Jan 1, 2023 – Dec 31, 2023: INR 45 cr. Turnover for Apr 1, 2023 – Mar 31, 2024: INR 51 cr. Can the turnover of the period in which the taxpayer prepares books of accounts in home country be used for determining threshold for application of PoEM as PoEM guidelines allow using the same for ABOI test?

The PoEM guidelines as well as the Act mentions about the financial year, hence, taking the accounting period of the home country seems inappropriate.

3. Where PoEM of a Non-Resident is determined later than the relevant FY, can it be held liable for the non-compliances?

CBDT² has laid down that in case PoEM of a non-resident is established in India, compliance with the TDS provisions as applicable to the non-resident prior to establishment of PoEM shall be considered sufficient compliance with those provisions. However, there is no clarity whether other provisions related to tax compliances including non-filing of the corporate tax return, non-payment of advance tax would constitute non-compliance if PoEM is established later for the specific period.

² Notification No. 29/2018/F. No. 370142/19/2017-TPL dated 22nd June, 2018.

4. Can the below facts fulfil the passive income test for determination of PoEM in India where entire purchases and sales are from/to AEs:

- a) Purchases from UK: GBP 10,000
- b) Sales to US: USD 15,000

Ironically, PoEM guidelines do not mention that AE transactions should involve an Indian AEs. Therefore, in the above example, there is a likelihood of the non-resident not satisfying the passive income test as the entire sales is to an AE from purchases made from AEs. Additionally, the non-satisfaction of even one condition out of the four (as discussed above) results in active business in India.

5. For manufacturing companies that purchase raw materials from both AEs and non-AEs, convert into finished goods and sold to AEs and third-party customers. In such case, how should the passive income be determined for ABOI test?

In the absence of clear guidelines, taking a reasonable approach of allocating the purchase price and conversion costs between AEs and non-AEs in the ratio of purchases from them. Post the same, income may be computed by reducing the bifurcated costs from the sales price.

6. In cases where a trading concern make purchases from AEs as well as non-AEs, it can be challenging to determine whether the sales made to AEs are out of the purchases from AEs or non-AEs for the purpose of passive income test?

Unlike in the case of manufacturing companies, a possible way to determine passive income in such instances is maintaining detailed records and mapping

entries to specifically identify the purchases made from AEs and non-AEs and corresponding sales.

7. Whether consultants, not on payroll of the company, who undertake back-office operations be considered as employees for ABOI test?

PoEM guidelines do not explicitly define 'employees', but it states to include 'those persons, who though not employed directly by the company, but perform tasks similar to those performed by the employees' in the definition of employees. Consequently, the consultants who perform tasks similar to those performed by regular employees may be deemed as 'employees' for the purpose of assessing ABOI test.

8. Due to the obscure definition of employees itself, whether directors/sitting fees made to such non-executive directors shall be included in payroll expenses is also ambiguous.

Theoretically, director/sitting fees are classified as professional expenses, and not employees cost (payroll expenses) in the profit & loss account. Further, non-executive directors should not be considered as employees, thus the corresponding expenses may be excluded from payroll expenses for ABOI test.

In light of the above discussion and illustrative practical challenges it is further challenging to accurately apply ABOI test, thus becoming a hindrance in the determination of PoEM in India for non-residents. Considering the same, it becomes pertinent that requisite clarity should be brought around PoEM for its smoother implementation. Clarity in PoEM framework would reduce the risk of litigation and boost taxpayer's confidence.

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