



Place of effective management: Domestic and international perspectives

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1. Introduction

Tax systems across the world use the twin rules of source and residence as connecting factors to tax the income of different persons such as individuals, companies, firms, etc.

The source rule checks where the particular income accrues or arises. If the income is determined to be sourced in a particular country, such country gets the right to tax the income. For example, income from transfer of a capital asset situated in India and a non-resident's income attributable to a business connection in India is covered under the deeming fiction of Section 9 of the Income-tax Act, 1961 ('Act').

The deeming fiction under Section 9 was considerably widened pursuant to the Finance Act, 1976. Income by way of fees for technical services paid by a resident or non-resident for services utilized in India (irrespective of the situs of rendering of services) and royalty income paid by a resident or non-resident for any right, property, information used or services utilized in India (irrespective of the situs of rendering of services) are two instances of incomes covered under the Act. The source based rules witnessed steady evolution on income arising from interest and income connected with employment in India. This has been a steady trend over the years. Post the landmark ruling on indirect transfers involving Vodafone², the Act was retrospectively amended to include, within the definition of an asset, shares of a foreign company deriving substantial value from the assets located in India³. Most recently, the business connection test has been expanded to include, with effect from April 2019, the concept of significant economic presence⁴. Interestingly, the significant economic presence test is not solely restricted to digital transactions. The recent change should be read in the context of changes India is likely to embrace via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ('MLI'). The wide source rules have been subjected to constitutional challenge on many occasions. In *GVK Industries Limited v. ITO*⁵ the Supreme Court held that laws with respect to extra-territorial aspects would not be *ultra vires* if there is a real connection to India, emphasizing Parliament's right to legislate law could entail extra-territorial jurisdiction.

The residence rule seeks to tax the income of persons considered to be residents as per the criterion identified in the law. The factors used to determine residential status of companies vary from incorporation in United States of America, to management and control in United Kingdom, Netherlands and Singapore to place of effective management ('POEM') in South Africa.

India historically used the test of incorporation and added POEM in 2016 to characterize a company as a resident under Section 6(3) of the Act. The focus of this chapter is on the POEM test which brings to tax, income of foreign companies whose place of effective management lies in India. Such income was not taxed under strict residence based principle for companies

² *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 613.

³ Section 9(1)(i), Explanations 4 to 7.

⁴ Section 9, Explanation 2A.

⁵ 2011 (3) SCALE 111.

incorporated outside India unless the entire management was situated in India. The Indian tax regime is a worldwide tax system, meaning, a resident has to pay taxes on his or her worldwide income to the Indian government. Hence, significant tax implications follow if a foreign company is considered to be resident, which hitherto taxed only Indian sourced income.

A point worth noting is that a number of India's tax treaties also contain the POEM test as a tie-breaker rule in Article 4(3)⁶ for resolving dual residency conflicts. The presence of the POEM test in domestic law as well as India's tax treaties makes for an interesting study resulting in friction between the domestic and treaty law.

Part II of the chapter discusses the justifications for the switch to the POEM test, the definition of the POEM test under the Act, related CBDT Circulars and the practical issues emanating therefrom in the context of select treaties. Part III of the chapter discusses the POEM test as a tie-breaker rule. The changes introduced pursuant to the adoption of the MLI are also discussed. However, it is only after India and its treaty partners have each notified the agreements intended to be amended under the MLI to the OECD Depository, scenarios under each treaty would emerge. As a sample, India's treaties with some key trade partners such as Mauritius, Singapore, Netherlands, United Kingdom, United States of America and South Africa are studied to examine how dual residency claims are to be dealt with. Part IV presents the concluding thoughts and comments along with some practical suggestions to ease implementation of the tie-breaker rule or case-by-case approach, as may be the case.

2. Concluding thoughts

Many of the sample countries here already use management based tests in their domestic law to resolve conflicts. However, the tests are not uniform; some countries may use a form over substance approach while others use substance over form. This could lead to conflicts. In such event, use of POEM as a tie-breaker becomes infructuous. Moreover, India's attempt of invoking the domestic law meaning may not go down well with other countries. India is yet to test the POEM test and rules from tax administration and judiciary view point.

India and other countries have to find ways of making MAP fruitful so that taxpayers do not suffer consequences of double taxation. For the same, apart from laying down norms of due procedure, it is important to think of other factors that can be used as tie-breakers. Countries must also consider taking the route of bilateral treaty negotiations for resolving meaning of POEM on a case by case basis rather than waiting for conflicts to arise to adopt MAP. Additionally, countries could include technical explanation to treaties as administrations deal with POEM cases.

⁶ Article 4 of a treaty (following OECD / UN Model Convention) states that residence is to be determined based on the domestic tax laws of each Contracting State. Upon application of domestic tax law, if both treaty partners consider a company to be dual resident, the tie-breaker rule of POEM is used to resolve the difference of opinion. For example, Article 4(3) of India – Denmark tax treaty reads as follows – “Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated”.