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An e-newsletter from
Lakshmikumaran & Sridharan, India

January 2016 / Issue–18

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January
2016

Article

Draft guidelines for determination of PoEM - A incongruous note to an intended harmonious provision?

By **Karanjot Singh**

Section 6(3) of the Income Tax Act, 1961 ('Act') has been amended vide Finance Act, 2015 to introduce the concept of Place of Effective Management ('PoEM') to determine residential status of companies. Memorandum to Finance Bill, 2015 provided that the amendment has been brought to align the provisions of the Act with the internationally accepted principles and to plunge the loopholes in the existing tax regime. It was further provided in the memorandum that a set of guiding principles would be issued for the benefit of tax administration and taxpayers.

On 23rd December 2015, CBDT notified a draft of guiding principles for determination of PoEM of Company. The main highlights of the guidelines are as follows:

1. Definition: PoEM has been defined to be 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. The definition is in line with the meaning of PoEM provided in the Act (vide Explanation to section 6(3) of the Act) as well as in paragraph 24 of the OECD Commentary on Article 4 (which was included in the 2000 update to the Model). In line with the commentary to the OECD model convention, the guidelines also recognize the fact that a company can have many places of management but only one PoEM.

Classification into 'Active' or 'Passive' business outside India

The guidelines propose to classify the business of the companies outside India into active or passive category. For the purpose of doing so, the guidelines propose that the following shall be considered to be passive incomes:

i) Income from transactions where both purchase and sale of goods is from/to its associated enterprise

ii) Income by way of royalty, dividend, capital gains, interest or rental income

Further, the guidelines provide that a company will be said to be engaged in active business outside India if the passive income of the company is less than 50% of its total income and if all the following conditions are satisfied:

i) If less than 50% of its total assets are situated in India, and

ii) If less than 50% of total number of employees is situated in India or resident in India and

iii) If the payroll expenditure incurred on employees situated in India and resident in India is less than 50% of its total payroll expenditure.

It is provided that for the purpose of determining whether the company is engaged in active business outside India (i.e. 50% of

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the criteria specified above) the average of the data of the previous year and two years prior to that shall be taken into account.

The guidelines provide that a company engaged in active business outside Indian shall be presumed to be a non-resident if the majority of meetings of the board of directors of the company are held outside India. However, it is proposed that if on the basis of facts and circumstances it is established that the board of directors of a company engaged in active business outside India are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person(s) resident in India, then the PoEM of such company shall be considered to be in India.

Determination of PoEM for companies engaged in passive business

The guidelines prescribe a two stage process to determine the PoEM for companies engaged in passive business. The first stage would be identification of persons which actually make the key management and commercial decisions for conduct of company's business. The second stage would be determination of place where these decisions are in fact being made. The guidelines clarify that the place where these decisions are taken is of more importance than the place where these decisions are implemented.

The guidelines recognize various locations such as the place where the board ordinarily meets, place of operation of a committee which has been delegated key business decisions by the board of directors and locations of company's head office as relevant places where the PoEM may be located.

Principles for guidance only

The guidelines provide that the set of the principles are directive in nature and that no single principle will be decisive in itself.

PoEM deemed to be in India

It is provided that if by applying the principles specified in the guideline, PoEM is in India as well as outside India, it shall be presumed that the PoEM is mainly in India.

Ever since the introduction of PoEM vide Finance Act, 2015, India Inc. had been waiting with antsy nerves for the guidelines for PoEM to be notified with a belief that the guidelines will notify a set of blanket rules or safe harbor principles for determination of PoEM in India. The draft guidelines are far away from that proposition. The guidelines are clarificatory in nature and principles are non binding. The only take away from the guidelines seems to be the fact that the substance shall prevail over form.

The classification of business into 'active' and 'passive', is a relatively fresh concept and does not find place in DTAA. The classification clarifies that the department wants to tax the 'letter–box' companies while intending to avoid litigation to determine the residential status of genuine companies which may have some sort of business connection with India but are managed from outside India. However, presumably with intent of plunging any loophole supplied by this deeming fiction (i.e. active companies holding majority of meetings

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outside India shall be non-residents), CBDT has notified that the concept of substance over form shall prevail even for active companies as even these companies can be declared residents if the board meetings are conducted merely on paper to hoodwink the department and actual decisions are taken from India.

Though such provision has been inserted with a prudent mind, this stand complicates rather than simplifying the current structure. This is because even when the assessee has satisfied that it is an active company, the department would still contest that it has its PoEM in India. Since the criteria as to when the PoEM of an active company will be in India have not been highlighted separately, the principles provided for determining PoEM of passive company shall apply to an active company as well. Thus this would make the entire exercise of classification of 'active' and 'passive' business redundant. The only breather to an assessee who is an 'active' company would thus, be that once it has been established by the assessee that it has active business outside India and that majority of board meetings have been held outside India, the burden to prove that the PoEM is in India will shift to department.

Another difficulty with the proposed guidelines is that though they provide that the average of 3 years data is to be considered while determining as to whether the business of the company is active or passive, at what point of time the average for each year is to be taken has not been clarified. E.g. if one needs to find out whether 50% of total assets were outside India, at what point of time in each year, the average needs to be calculated has not been provided. Since the assets and employees are not constant throughout the year, a clarification with respect to this calculation would be welcome.

In general parlance, the term 'passive income' is used for incomes which can be earned without active participation or effort. Royalty, dividends, capital gains and rental incomes should and have been classified as passive incomes. However, the guidelines provide that where a company is engaged in the business where both sale and purchase are from/to related parties, the same shall be classified as passive business. It seems that the intent for introducing this provision is to curb the practice where companies create intermediary shell companies and park profits outside India by using provisions of DTAA. It is however pertinent to note that the Board has included only purchase and sale of goods within the ambit of passive income transactions. Provision of services to and from related parties has not been covered within the scope of passive incomes.

The major drawback with the guidelines however, is the fact that the principles are non binding and that the PoEM shall be deemed to be in India if the application of principles imply that PoEM is India as well as outside India. Firstly, it is a settled principle which is recognized by the OECD and endorsed by the guidelines issued by CBDT itself that there

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can be only one PoEM. Thus, the fact that application of principles notified by CBDT can lead to more than one place of PoEM cannot be appreciated. If the intent was to align the Act with the internationally accepted principle, the guidelines should have been drafted to deal with a situation where PoEM 'cannot be determined' rather than providing a situation where PoEM is 'in India as well as outside India'. Secondly, such a deeming provision can lead to disastrous results as DTAA does not recognize such a deeming provision and application of such a provision will lead to double taxation. It is understood that the credit of taxes may be available but supplying such a provision without providing for any basis of doing so is difficult to digest. Thus, inserting such a deeming guideline is in variance with internationally accepted principles.

Conclusion

The draft guidelines issued by CBDT are not only open ended but contradictory to the internationally accepted principles for determination of PoEM. The guidelines should have been in harmony with the OECD commentary which was one of the intent of introducing the provision. The corporate sector would thus wait for the final guidelines hoping that the final version of the guidelines include some sort of safe harbor principles for determination of PoEM.

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Notifications and Circulars

Protocol amending the DTAA between India and Belarus

A protocol has been entered into by the Government of the Republic of India and the Government of the Republic of Belarus amending the Double Taxation Avoidance Convention (DTAC) signed between India and Belarus in 1998. Through this protocol, an internationally accepted standard, relating to effective exchange of information on tax matters including bank information has been inserted.Notification No. 2/2016 (F.NO.501/07/1999-FTD-I)], dated 13-1-2016 has been issued in this regard.

Income-Tax Department's communications are now available on Twitter Account

The widespread of social media communications has encouraged the government ministries and departments to post their communications on internet. Now the Income-tax Department has proposed to have a user friendly interface on social media sites, like Twitter, Facebook and YouTube. The Department has opened the official Twitter account@*IncomeTaxIndia* (refer Office Memorandum dated 04.01.2016).Initially, the content published by the Twitter account will consist of press releases and any dissemination of information in the form of advertisements. A dedicated email address *socialmedia@incometax.gov.in* has also been created for the same.

Deductors can now validate certificates for deduction of TDS at lower rates

The Board had earlier issued Instruction No.

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36 dated July 15th, 2009 to all tax officers to quote a unique number for all lower TDS certificates issued and had sought all tax officers to monitor those certificates from time to time. The deductors have to quote such unique TDS certificate numbers in the TDS/TCS statements. Now, the Board *vide* Press Release dated 1-1-2016, has identified that a huge default of 'Short Deduction' was caused due to wrong quoting of unique certificate number. To arrest this wrong quoting of unique certificate number, a facility for validating the certificate on *www.tdscpc.gov.in* (TRACES) has been introduced. This enables a deductor to first validate the certificates given to him by the deductees and then furnish the same in the TDS/TCS statements.

Pending notification on electronic filing of appeals before first appellate authority

As part of digitization, the tax department has announced, *vide* Press Release dated 30-12-2015 electronic filing of appeal before the Commissioner of Income Tax (Appeals). It is proposed to ask all the Assessees who are required to file the return of income electronically to file appeals also electronically. A new form in place of Form 35 will be prescribed. However, amendments to the rules and forms are yet to be notified.

No TDS on interest accrued until beneficiaries are ascertained

The Delhi High Court in the case of *UCO Bank*{[2014] 51 taxmann.com (Delhi)} held that the provisions of Section 194A do not apply to fixed deposits held in the name of Registrar General of the Court on the directions of the Court during the pendency of proceedings before the Court, as the beneficiary of the fixed deposits, amount and year of receipt are unascertainable. The Board has accepted the aforesaid judgment and accordingly, clarified *vide* Circular No. 23/2015 dated 28-12-2015 that interest on Fixed Deposit Receipt (FDR) made in the name of Registrar General of the Court or the depositor of the fund on the directions of the Court, will not be subject to TDS till the matter is decided by the Court. However, once the Court decides the ownership of the money lying in the fixed deposit, the provisions of Section 194A will apply to the recipient of the income.

Updated guidance note on implementation of FATCA Rules

By way of Notification No. 62 dated 7-8-2015, the Central Government had notified Income-tax (11th Amendment) Rules, 2015 (Rules), Rule 114F to Rule 114H, incorporating the requirements of the Inter-Governmental Agreement signed by the Government of India with the Government of the United States of America for compliance with Foreign Account Tax Compliance Act (FATCA) and the requirements of the Common Reporting Standard (CRS) issued by the Organization for Economic Co-operation and Development (OECD).

In this regard, a draft guidance note on implementation of reporting requirements under Rules 114F to 114H was released on 31-8-2015 has been issued and feedback / suggestions from all stake holders was sought.

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On 31-12-2015, the Government of India has released an updated version of this Guidance note.

The updated guidance note clarifies the following:

- HUF should be treated as an 'Entity' for the purpose of compliance with the Rules.
- The term 'Financial Institutions' exclude insurance companies that only provide general insurance or term life insurance and reinsurance companies that only provide indemnity reinsurance contracts.
- Non-Banking Financial Companies would be considered as 'Depository institution'.
- Investment entities would include collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any other similar investment vehicle established with an investment strategy of investing, reinvesting or trading in Financial Assets.
- A draft format of self-certification has been released which can be used by the reporting financial institutions for the purpose of the undertaking due diligence of financial accounts maintained by them.
- Other clarifications includes, clarification on aggregation rules – exempt products, clarification on Tax Identification Number (TIN), Clarification with respect to controlling person, etc.

CBDT clarification on non-imposition of penalty when income determined under the general provisions is less than the income declared for the purpose of MAT for period prior to 2016

Explanation 4 to Sec 271(1) of the Act has been substituted by Finance Act 2015 to provide a method for calculating the amount of tax sought to be evaded in cases where the income determined under the general provisions is less than the income declared for the purpose of MAT u/s 115JB/115JC. The CBDT clarified, vide Circular No. 25/2015 dated 31.12.2015 that the amendment would not operate retrospectively and that for cases prior to 01.04.2016, if any adjustment is made in the income computed for the purpose of MAT, then the levy of penalty u/s 271(1)(c) of the Act, will depend on the nature of adjustment. *[For more details refer to L&S Tax Track No. 3.46]*

Ratio decidendi

Depreciation 'allowable' to be deducted from block of assets even if not claimed and allowed: Agreeing with the interpretation put forward by the Revenue Authorities ('RA'), the Delhi High Court held that in case of slump sale of an undertaking as a going concern, depreciation as would have been allowable has to be reduced from the value of assets to arrive at net worth of the undertaking, even if no depreciation as claimed or allowed to the transferor of the undertaking. The High Court further held that the fact that the transferor did

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not claim the same was not relevant for purpose of computing value of assets to determine capital gains. [*CIT* v. *Dharampal Satyapal*, ITA 1003/2011, Delhi HC judgement dated 6-1-2016]

Consideration for technical data supplied- Not taxable as FTS : The taxpayer had made certain payment for obtaining certain technical study data without deduction of tax at souce. The RA contended that the payment would be regarded as Fee for Technical Services ('FTS') and accordingly would be subject to withholding tax. The High Court observed that payment for obtaining study data cannot be regarded as payment for rendition of technical services and consequently would not be subject to withholding tax in India. [*CIT (TDS)* v. *Heramec Ltd*, 2016-TIOL-59-HC-AP-IT]

Advance to AE for business purpose – Not an international transaction: The taxpayer had given certain advances to its Associated Enterprise (AE) which had inturn made advances to third parties for acquiring certain business assets for the taxpayer. The RA treated the advance made to AE as an international transaction and made transfer pricing adjustment by imputing interest at market rate on the advances. On appeal, the Tribunal held that the advance was only routed through the AE and was not made to the AE. Accordingly, the Tribunal concluded that the transaction cannot be regarded as an 'international transaction'. [*KSS Ltd* v. *DCIT*, ITA NO. 1061/Mum/2015, ITAT, Mumbai order dated 9-12-2015]

Transfer of shares to AE – Losses may not be allowed to be carried forward: Pursuant to restructuring within the group, the shares of the taxpayer were by the holding company transferred to another AE in Singapore. The RA denied carry forward of losses of the taxpayer on the ground 51% of shareholders in the year of set off of losses were different from shareholders of the year in which losses were incurred. On appeal, the High Court held that losses could not be carried forward due to change in shareholding pattern, despite the fact that shareholders were part of the same business group. [*Yum Restaurants (India) P Ltd* v. *ITO*, ITA 349/2015, Delhi HC judgement dated 13-1-2016]

Failure to file revised return, when no concealment of income, would not attract penalty: Setting aside penalty imposed for furnishing inaccurate particulars, the Tribunal held that mere failure to file revised return, when original return was correct at time of filing, cannot invite penalty. The taxpayer carried forward losses when demerger was being planned but have not been sanctioned by the High Court. It had furnished information about the proposed demerger from time to time to the TA but omitted to file revised return after the demerger was approved by the High Court. In an appeal against imposition of penalty for filing of inaccurate particulars, the ITAT held that the original return was correctly filed as per the facts prevailing on the date of filing the return, it cannot be held to be an attempt to conceal or furnish inaccurate particulars of income. [*Associated Stone Industries (Kotah)*

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Ltd v. *ACIT*, ITA No. 512/JP/2013, ITAT Chandigarh-Jaipur order dated 8-1-2016]

Shares tendered under buy back scheme - not 'reorganization': Transfer of shares held by non-resident under a buy-back scheme followed by reduction in share capital of the (buyer) company is not 'reorganisation' of business for purpose of India-Netherland DTAA. Deciding thus, the ITAT held that the capital gains resulting from such transfer is taxable in the hands of the non-resident taxpayer. The taxpayer, which sold shares held by it in an Indian company contended that since this was as per the arrangement for buy-back of shares where after the share capital of the Indian company was reduced since the shares were cancelled, the capital gains were not taxable. However, the Tribunal found force in the argument that there was no change in the financial structure of the company since the rights and interests of shareholders and the impugned arrangement was only an exit route for the non-resident shareholder. [*Accordis Beheer BV* v. *DIT (IT)* ITA No. 4688/Mum/2010, ITAT Mumbai order dated 13-1-2016]

Capital gains on shares registered in name of spouse – When income cannot be clubbed: Capital gains arising outside India, remitted to India cannot be taxed at the hands of the non-resident by clubbing it with the income of resident wife. The taxpayer, a non-resident had received shares as part of performance bonus. They were registered in the name of his wife-resident in India but sold in London where the assesse was employed. The proceeds were remitted to India. The RA claimed that the gain arising on sales arose in India and the amount received in the joint account of the taxpayer and his wife was taxable in India. The Tribunal however, held that though the shares were registered in the name of the wife, the taxpayer was the owner as per the terms of issue and the gains arose outside India. Hence, it could not be taxed in India and there was no case to club the income even if it was transferred for inadequate consideration since the asset arose outside India. [*Rajendra Pathak* v. *ADIT (IT)*, ITA No.53/JP/2012, ITAT, Jaipur order dated 11-8-2015]

Sale of 100% share – Not necessarily slump sale of undertaking: The taxpayer had transferred 100% shareholding in its subsidiary and had offered the gains to tax as long term capital gain. The RA contended that as complete interest and control over the subsidiary is transferred, the transfer would be regarded as a slump sale. On appeal, the Tribunal held that transfer of shares in a subsidiary cannot be regarded as transfer of an undertaking and consequently cannot be regarded as slump sale. [*UTV Software* v. *ACIT*, ITA No. 3148/mum/2013, ITAT Mumbai order dated 9-12-2015]

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