

PLACE OF EFFECTIVE MANAGEMENT

- Dr. Vipin Kumar^{*}

1. INTRODUCTION

The residential status of a person is an important issue under international taxation. Article 1 of the OECD and UN model conventions expressly make the double taxation avoidance agreements applicable on persons resident of either or both of the contracting states. Article 4 provides for the tie-breaker rule in case the person is resident of both the states. Article 1 read with article 4 acts as an anti-avoidance measure as they tend to confer treaty benefits only on residents. However, the rules regarding residential status of a person are not mentioned in model conventions. The rules are left to the individual states to be decided through their domestic statutes. The states are free to lay down any criterion, inter alia, domicile or nationality or period of stay or effective management.

The Income Tax Act, 1961 follows different criterion for different persons like individuals, Hindu Undivided Family (HUF), companies etc. The rules regarding residential status of an individual or HUF have not raised much controversy as compared to rules regarding residential status of a company. This article specifically deals with rules regarding residential status of a company in the changing scenario. The author has made a humble attempt to evaluate the present parameter, which has been recently introduced in Income Tax Act, 1961 for residential status of a company.

2. EVOLUTION OF CONCEPT REGARDING PLACE OF EFFECTIVE MANAGEMENT

^{*} Assistant Professor of Law, Rajiv Gandhi National University of Law, Punjab.

Prior to the amendment of section 6(3) of *Income Tax Act*, 1961, a company was said to be resident in India if: (a) it was an Indian company, or (b) if during the relevant previous year, the control and management of its affairs was situated wholly in India. Thus, a company was non-resident company if: (a) it was not an Indian company, and (b) if the control and management of its affairs was situated wholly or partially outside India. The term '*control and management*' was interpreted as central controlling power and not day-to-day affairs of the company. As the central controlling power vests with the board of directors, the place where meetings of Board of Directors were held was a determining factor to decide '*control and management*' of the company. A foreign company could be termed as resident in India if its Board of Directors meetings took place in India. The situs of shareholders or their meetings was held to be insignificant for determining the '*control and management*' even if they are the ultimate owners, as in fact, the control and management vests with Board of Directors.¹

The rules regarding residential status of a company was reconsidered by the Direct Tax Code.² Direct Tax Code proposed that a company should be resident in India if: (a) it was an Indian company, or (b) if its place of effective management, at any time in that year, was in India. Thus, the Direct Tax Code intended to shift the focus from '*control and management*' of a foreign company to '*place of effective management*'. This was the first time when concept of '*place of effective management*' gained recognition in India.

The Parliamentary Standing Committee on Finance, in its forty-ninth report on Direct Tax Code bill observed that the definition of place of effective management was unclear and provided room for uncertainty. It recommended that residential status of a foreign company should be based on internationally accepted standards and judicially settled principles where there is a focus on place where key management and commercial decisions as a whole are made or where the '*head and brain*' of the company is situated.³

Be it as it may, the Direct Tax Code has been shelved and the necessary amendments have been brought in the *Income Tax Act*, 1961 itself.⁴ The

¹ Radha Rani Holdings Pvt. Ltd. v. ADIT, (2007) 16 SOT 495 (Del).

² *Direct Tax Code*, clause 4.

³ Parliamentary Standing Committee on Finance, *Forty-Ninth Report on Direct Tax Code Bill*, 2011-12.

⁴ The *Income Tax Act*, 1961, section 6(3).

Finance Act, 2015 has amended section 6(3) of the *Income Tax Act, 1961*. The amended provision reads as follows:

Section 6 (3): A company is said to be resident in India in any previous year, if –

- (i) it is an Indian company; or
- (ii) its place of effective management, in that year, is in India.

Thus, the concept of ‘control and management’ which decided residential status of foreign companies has been done away with. The statute now recognizes ‘place of effective management’ as the determining factor for residential status of foreign companies.

The explanation attached to the amended section 6(3) of the *Income Tax Act, 1961* states that ‘place of effective management’ means 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. However, this explanation does not clarify the meaning of ‘place of effective management’ with certainty.

The explanatory notes to the provisions of the *Finance Act, 2015*⁵ state that the earlier concept of ‘control and management’ had become impractical as a company could easily avoid becoming a resident by simple holding a board meeting outside India. This could facilitate creation of shell companies, which are incorporated outside but controlled from India. The explanatory notes justify ‘place of effective management’ on the grounds that it is an internationally recognized concept. Further, it states that most of tax treaties entered into by India recognize the concept of ‘place of effective management’ for determination of residence of company as a tie breaker rule for avoidance of double taxation. However, it merely reiterates the wording of explanation attached to section 6(3) and does not explain the meaning of this term with certainty.

Realizing the need to explain the concept of ‘place of effective management’ and in compliance with the statement made in explanatory memorandum to the *Finance Bill, 2015*, the Central Board of Direct

⁵ Central Board of Direct Taxes, *Circular No. 19/2015*, dated 27 November 2015.

Taxes framed draft guiding principles for determination of place of effective management of a company. The document containing draft guiding principles was put in public domain for comments and suggestions.⁶

3. GUIDING PRINCIPLES ISSUED BY CBDT FOR DETERMINING PLACE OF EFFECTIVE MANAGEMENT

The Central Board of Direct Taxes has adopted a cautious approach while laying down the guiding principles for determination of place of effective management as if the assessing officer once decides that the foreign company has its place of effective management in India, then such company becomes a resident of India. The scope of its total income shall now include both Indian and global income. The guidelines provide two important checks on exercise of powers by the assessing officer. Firstly, the assessing officer shall seek the approval of Principal Commissioner or Commissioner, as the case may be, before giving finding which holds a foreign company as resident in India on the basis of place of effective management. The Principal Commissioner or the Commissioner shall provide an opportunity of being heard to the company before deciding the matter.⁷ Secondly, the residential status of a company shall be determined on year-to-year basis and there shall be no blanket decision for a number of years.⁸

The Central Board of Direct Taxes categorically lays down that place of effective management depend upon the facts and circumstances of a given case. It should not be determined on isolated facts. A 'snapshot' approach should be avoided and activities performed over a period, during the previous year, need to be considered.⁹

The guiding principles lay down concept of 'active business' as a starting point of any probe to decide place of effective management of a company. The guidelines state that a company shall be engaged in active business outside India if: (a) the passive income is not more than 50% of its total income and (b) less than 50% of its total assets are situated in

⁶ Central Board of Direct Taxes, *Circular No. 142/11/2015-TPL*, dated 23 December 2015.

⁷ *supra*, at para 11.

⁸ *id.*, at para 6.

⁹ *id.*, at para 10.

India and (c) less than 50% of total number of employees are situated in India or are resident in India and (d) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure. The foreign company having active business outside India shall be presumed to be non-resident if the majority of meetings of the board of directors are held outside India. However, if the board of directors have delegated their power to a person resident in India or holding company in India, then the place of effective management shall be considered to be in India and the foreign company shall become resident in India.¹⁰

For foreign companies other than those engaged in active business outside India, the guidelines lay down two-stage process to decide place of effective management. The first stage is identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole. The Second stage is determination of place where these decisions are in fact being made. The place where these management decisions are taken is more important than the place where such decisions are implemented.

The guidelines also lay down certain parameters, which should be taken into account for determining place of effective management in case active business is outside India. They are as follows:

- (i) Location where a company's board regularly meet, if they retain the authority to make key management and commercial decisions. Otherwise, the place where other persons on whom this power has been delegated meet;
- (ii) Location of company's head office, if the company has a centralized management system. Otherwise, the place where senior managers along with their supporting staff are located;
- (iii) Place where main and substantial activity of the company is carried out; and
- (iv) Place where accounting records of the company are kept.

The guidelines prescribe that in case meetings are held through use of modern technologies like video conferencing, the place of effective

¹⁰ *id.*, at para 7.

management should be the place where senior managers or persons taking key management and commercial decisions actually located.

Thus, the guidelines tend to make a comprehensive structure for deciding place of effective management, which is *sine qua non* for judging the residential status of a foreign company.

4. ISSUES FOR CONSIDERATION WHILE DETERMINING PLACE OF EFFECTIVE MANAGEMENT

Merwe, in his article, lays down five important issues for consideration while determining place of effective management in South Africa's context.¹¹ These five issues are equally important in Indian context. They are discussed as follows:

4.1. Who Manages A Company?

There is difference between shareholders' control and management of a company. The shareholders may be the owner of a company, however, the ultimate management vests with the board. The board may exercise this control on their own by making key management and commercial decisions themselves or they may delegate it to some organ / board committee / senior managers / shareholders etc. Thus, the situs of board's meeting or location of the person / organ on whom the authority has been delegated becomes important. CBDT guidelines also lay stress on the location of board's meeting or in case powers are delegated, to the location of persons / managers / organs on whom these powers have been delegated.

4.2. Level of Management:

The level of management which is important for determination of place of effective management is the superior management instead of daily hands on management. Thus, it is the situs of organ / location of persons taking superior management decisions important. The location of managers exercising daily hands on control is not important. The CBDT guidelines also lay stress on the superior level of management. It categorically lays down that day to day routine operational decisions

¹¹ BA Van Der Merwe, *Residence Of A Company – The Meaning of Effective Management*, 14 South African Mercantile Law Journal 79, 92 (2002).

undertaken by junior and middle management shall not be relevant for the purpose of determination of place of effective management.

4.3 Nature of Effective Management.

The term 'effective management' is ambiguous. This test is difficult to apply. It depends on the facts and circumstances of each case. However, effective management is a rule of substance over form. It is better than rule of incorporation as incorporation is open to manipulation. The CBDT also admits this fact. The guidelines expressly mention that the test relating to place of effective management is a rule of substance over form.

4.4 Guidance from Meaning of Management and Control.

The term 'management and control' as used in the *Income Tax Act, 1961* may be comparable to 'place of effective management' but not identical. They are comparable as both refer to superior level of management and not the day to day control. However, the difference between these two concepts lie in the fact that 'management and control' may invariably yield multiple residences whereas 'place of effective management' can yield only one residence.¹²

4.5 Situations Where Company has More Than One Place of Effective Management.

The CBDT clearly states that there can be more one place of management but there can be only one place of effective management. Thus, in cases where there are more than one place of management, the dominant place shall be the place of effective management.

5. CONCLUDING REMARKS

The introduction of concept regarding 'place of effective management' is definitely an important milestone under *Income Tax Act, 1961* as it is a rule of substance over form. However, it raises many issues, which shall remain unsettled until a clear verdict comes from the constitutional courts or CBDT clarifies its stand. Firstly, the sanctity of tax residency certificate issued by the foreign jurisdiction to the foreign company shall be doubted unilaterally by the income tax department of India. The

¹² *supra*11, at p. 92.

foreign company may end up being a resident in both the states. Secondly, the tie breaker rule for resolving dual residency position of the foreign company shall become ineffective as place of effective management itself is a tie breaker rule under tax treaties. Thirdly, the applicability of tax treaties shall become an issue in triangular cases where the company is incorporated in a third state. Further, the issues relating to applicability of lower rate of withholding tax and applicability of minimum alternative tax shall arise. It is desired that these issues are taken up by the CBDT at the earliest possible opportunity and resolved to the best interest of all stakeholders. It shall provide clarity to the foreign companies and promote foreign direct investment in India.