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# 'Direct Tax Code-

Controlled Foreign Company and  
Place of Effective Management



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## Direct Tax Code - CFC and Place of Effective Management

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The introduction of Direct Taxes Code, 2010 (DTC 2010) in the Parliament reaffirms the Government's resolve to push forward the direct tax reforms process, to bring the Indian legislative framework in line with the global practices. The provisions incorporated in the revised Bill are well intentioned and do address, to some extent, the concerns articulated by the industry on the proposals contained in the initial Code. Most of the aspects of the Bill have been well debated and analyzed. However, two elements of international taxation - the proposals relating to the 'Controlled Foreign Company' (CFC) and the 'Place of Effective Management' (POEM) - merit a revisit as these could have a significant impact on the international transac-

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tions. As worded presently, the provisions would be contrary to the basic tenets of the DTC, that of simplifying the law, reducing subjectivity and ambiguity and the resultant scope for litigation.

Many jurisdictions across the globe have adopted the CFC legislation to counter the use of tax havens. US was perhaps the first country to adopt CFC rules in 1962, followed by Canada (1972), Germany (1972), Japan (1978), France (1980), UK (1984), NZ (1988) and Australia (1990). The emerging countries including Mexico, Argentina, Indonesia, South Africa, Estonia and China also joined the CFC club. More than 25 countries at present have CFC regulations in place.

In the Indian context, the proposal to introduce CFC provisions was first mooted in 2003 by the Working Group on Non-resident Taxation appointed by the Government. Introduced for the first time in DTC 2010, the CFC provisions are designed to prevent tax deferral and tax avoidance by residents, including domestic companies

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looking to establish foreign entities/subsidiaries, in low tax jurisdictions and diverting income to them.

India continues to be a net importer of capital, with the outward FDI a mere USD 12 billion as against USD 31.7 billion inward FDI during 2009-10. Given this, concerns do arise about the timing of implementing the CFC provisions in India as the complex and cumbersome provisions could have significant impact on the offshore investments and strategic decisions by the Indian companies who have only begun to spread their wings globally.

As per CFC provisions, the passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes is proposed to be taxed in India in the hands of the resident shareholders as residuary source income. Passive incomes not only include interest, royalty, rent, capi-

tal gains, dividends but also income from active trading with related parties.

There could be many instances where passive income could include genuine commercial activities by virtue of its nature. For instance in view of excess capacity, leasing of an airplane by an airlines company to third party for genuine commercial reasons may attract taxation under the CFC regulations as passive rental income, even though the payment was received in the course of active business. Same could be the case for leasing of a shipping vessel. The US CFC rules provide for an exception to certain passive income such as interest, rent and royalty to the extent that payments are derived in the active conduct of a trade or business. A similar approach could be adopted under the Indian rules.

Many countries provide a 'motive' exemption for CFCs which are not established for the purpose of avoiding domestic tax but purely for commercial reasons. A similar exemption would be desirable in the Indian context too.



CFC rules apply to foreign companies over which a resident taxpayer has 'control'. Control can be *de jure* (50% or more control over voting power or capital) or *de facto* or a combination thereof, of substantial interest/influence or control over income or asset of the CFC. Control test can be fulfilled at any time during the year and based on the test a foreign company can be CFC even for a part of the year.

The definition of control needs to be sharpened to bring greater clarity. Control should mean more than 50% control over voting power or capital (instead of 50 percent or more), as is also the case in the US and UK CFC regulations. Moreover, the multiplicity of subjective criteria listed out for satisfying the control test is likely to lead to substantial ambiguity. The criteria include acquisition of shares with at least fifty percent voting power or capital, securing at least fifty percent of income or asset for person's benefit, domi-

nant influence on the company due to contractual relationship and decisive influence in a shareholder meeting. Many aspects within these parameters such as dominant/ decisive influence and entitlement to acquiring voting power through derivative instruments or indirect holding are not defined and are open to interpretation.

The DTC provisions provide no clarity about the credit of foreign taxes paid on the passive income and deduction of eligible expenditure against the passive income while computing CFC's tax liability in India. The government could provide for an underlying tax credits mechanism in India (as suggested by the Non-resident Taxation Working Group) under which credit is given by the country where the parent company is a resident, not only for the tax withheld at source on the dividend payout by the overseas subsidiary but also in respect of the tax suffered on distributable profits.



In view of the numerous complexities that are likely to arise in the implementation of the CFC regulations, our growing investment needs and the limited capital convertibility, it may be premature for India to adopt these regulations. However, if introduced, it would be important to ensure that the regulations are unambiguous and do not increase compliance burden on the companies.

Moving on to the issue of POEM as a test of residency, the DTC 2010 introduced this concept to address the widespread concerns over the narrow definition given in the DTC 2009 that had proposed that a company incorporated outside India would be treated as a resident in India if its place of control and management at any time during a tax year is situated wholly or partly in India.

The Revised Discussion Paper on DTC 2010 explained the POEM concept as the place of central control and management where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made. The DTC Bill defines POEM as the place where the board of directors of the company or its executive directors make their decisions; or in a case where the board of directors routinely approves the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers perform their functions.

A defined POEM rule helps determine the place of residence for companies incorporated overseas. However, one would need to be cautious about the requirement that the POEM at any time in the year would trigger residency. Further, dealing with the decisions of executive directors

could create uncertainty and be a problematic issue not just for foreign companies doing business in India but Indian companies with overseas operations. Residence ought to be a place where the Board or the executive directors 'regularly' make their key management and strategic decisions to avoid controversies on account of a stray board meeting in India or stray decisions being taken by an executive director while being physically in India. It would be advisable that the decisions of the Board at such meeting are well debated from all business and strategic angles and there is evidence to support democratic process of taking decisions.

Similarly, the reference to commercial decisions needs to be reviewed since it is very wide in its import and per se does not relate to strategic decision making. There are other fundamental issues that need greater clarity. For instance, should the trigger be limited to the ED making decisions affecting the Central Management alone and not when it relates to one of the divisions? One would also need to evaluate aspects relating to authorization of the EDs in the Articles of a company, supervision by the Board and interpretation of "executive director" and "officers" in terms of the Companies Act. The impact of presence of directors or officers in different jurisdictions would also need to be studied. Further, phrases such as 'perform their functions' are subjective in nature and could fuel uncertainty.

The Direct Taxes Code would undergo further scrutiny as it has been referred to the Parliamentary Standing Committee of Finance. Given the significant impact of the above issues, it is hoped that the relevant provisions would be closely examined to ensure that the objectives of the tax reform are not diluted.

**Disclaimer : Views of the author are entirely personal**