

To,

2nd January, 2016

Mr. Ashish Kumar
Director (Tax Policy & Legislation) – 1, CBDT
Ministry of Finance, New Delhi

Dear Sir,

RE: IVCA Representation on Draft Guidance on POEM

IVCA members greatly appreciate the reforms being undertaken by the Government.

IVCA's private equity and VC community has invested over \$ 100 billion in Indian ventures including start-ups and growth ventures during the past 16 years.

At the outset, we appreciate the steps taken by the tax administration in engaging with stakeholders to create consensus on POEM. We are confident that an appropriate policy decision can be made that is the best interest of the country and the economy.

A. We refer to the amendment to Section 6 of the Income Tax Act, 1961 (vide Finance Act, 2015) which introduced the concept of place of effective management ("POEM") as the new criterion for corporate tax residence in India. This changes the fundamental basis of taxation in India and is therefore a very serious matter for Indian MNCs, foreign companies, investment funds and start ups. It also creates a risk of double taxation that is not addressed by tax treaties. Further, it would create huge administrative and enforcement challenges for the tax department.

In view of the wide ramifications of the changes proposed, we request that the finalization of the draft guidance on POEM be deferred for 2 months till there is a more comprehensive review of the issues involved and full consensus among stakeholders.

There is a compelling basis for India to revert to the earlier criterion of residence based on place of incorporation which was introduced in 1922 as an improvement over POEM. Several countries including the US do not use POEM as a criteria for residence.

We believe that a US-style objective criteria of residence based on place of incorporation along with introduction of a well defined controlled foreign corporation ("CFC") rules would sufficiently address the concerns of the tax

department and yet provide certainty to taxpayers. This would also be consistent with OECD's Base Erosion and Profit Shifting ("BEPS") Action Plans which India has endorsed.

B. Key Issues and Difficulties with POEM concept

1. POEM is not an international standard: The stated objective behind the amendment is that POEM is an internationally recognized concept and is also accepted by the OECD. However, several countries including the US, Japan, Brazil, Argentina, Sweden, Finland, Indonesia, Philippines and many others do not use POEM as a criteria for corporate residence. Many countries use place of incorporation as a residence threshold which is a more objective standard. Most countries that use POEM have tax systems where the risk of litigation is not significant. In such countries, the jurisprudence and practice are well settled and companies do not generally consider POEM as a risk factor while managing their global operations.

2. Earlier residence standard superior to POEM: Prior to introduction of POEM in 2015, the earlier residence criterion was based on place of incorporation or the place where the company was 'wholly' controlled and managed. This standard was introduced in the Income Tax Act of 1922 as an improvement over the antiquated concept of place of effective management (in Europe) and central control and management (in the UK). This was reviewed in the 12th Report of the Law Commission and continued in the Income Tax Act of 1961. For almost 100 years, there was hardly any litigation in India on the issue of corporate residence. The earlier objective standard of corporate residence provided immense certainty to both taxpayers and the tax administration.

3. Subjective rules increase litigation risks and uncertainty: We appreciate the recent instructions by the tax administration aimed at restricting high pitched and frivolous assessments. We also appreciate the proposal for POEM cases to be reviewed by the Commissioner. In terms of policy, it is important to address the root cause for uncertainty and litigation which is subjective tax rules. A matter as fundamental as a company's residence should have an objective criterion without which no company can plan its business affairs. The subjective standard of POEM will increase litigation risks and create interpretational challenges for both taxpayers and tax officers.

4. Significant risk of double taxation: A unilateral interpretation by India of POEM would result in double taxation since there is no guarantee that the treaty partner will accept India's determination of a company's POEM. Both countries may tax a

company on worldwide income and the company will face challenges in claiming tax credits. This risk is more significant for US companies founded or held by India based MNCs and entrepreneurs since the India-US tax treaty does not recognize the concept of POEM.

The US is likely to remain a major partner for investment and transfer of technology, and the risk of double taxation would have serious consequences. The only way to possibly guarantee that there will be no double taxation is to enter into specific agreements (either as a treaty protocol or through mutual agreement procedure) with each country to clarify the scope of POEM with respect to the relevant treaty. This may be a challenge to implement.

5. High cost of enforcement and difficulties for tax administration: The cost of objectively determining POEM of a foreign company including securing and analyzing relevant information itself can be quite prohibitive. This may require analysis and review of stacks of documentation and emails in relation to decision making which will be impossible to obtain in most cases. Subjective rules make it difficult for tax officers since it may result in varying interpretations and greater risk of adverse internal scrutiny. Costs associated with increased litigation will impact the Government as much as the taxpayer. It is also important to consider other costs. For example, overseas funds and financial institutions treated as Indian residents based on POEM may be subject to reporting obligations under the US-India FATCA treaty and the Government would have to put in place a mechanism to collect and transmit such information.

6. Risk of making India Inc. non-competitive: If POEM is introduced, Indian MNCs and start-ups would have to carefully factor the risk of global taxation (and double taxation) of their overseas subsidiaries to the extent there is management and oversight from India. This can complicate globalization efforts and significantly increase costs of managing overseas subsidiaries or holding companies. It will reduce competitiveness of Indian companies vis-à-vis global peers including US companies and startups who do not have to factor POEM related tax risks while building global enterprises.

7. Risks for venture capital, private equity and other funds: Boosting inbound investment in various sectors including infrastructure is vital for India to sustain its high growth rate. With sluggishness in other economies, this is a crucial time for India to differentiate itself and capture a bigger proportion of global investment flows. Investments by venture capital, private equity and other funds is integral to this growth story. However, the uncertainty on tax residence and risk of double taxation will adversely affect overseas funds and any increase in litigation risks can

impact exposure of such funds to India. Overseas funds investing into India and foreign investors in alternative investment funds (AIFs) should be exempt from the POEM rules. This is in line with the Government's policy to incentivize fund raising in India including the liberalized FDI norms with respect to AIFs, and the policy to provide relief to specific overseas funds against PE and tax risks in India. There is a need to carefully analyse the impact of the POEM guidelines so as to not undo the positive measures introduced.

8. Risk of accelerating Brain Drain: With the implementation of POEM, there is further incentive for Indian companies to relocate founders and senior management overseas to minimize the additional tax exposure and risk of double taxation. In recent times, there has been a noticeable exodus of top fund managers from India many of whom had returned to India in the last few years. Several high profile NRIs have also been dissuaded from coming back. Such trends can defeat the Government's active efforts to promote the much celebrated 'Make in India' initiative, since subjective rules like POEM would make it difficult to do business in India.

C. Recommendations

1. More time for review: Considering the serious and widespread ramifications of POEM, it is important not to introduce and enforce such rules in haste. The draft guidance was announced around 9 months after the effect date of POEM. Any decision to implement subjective rules such as POEM should be deferred until there is a more comprehensive review of these rules and its impact in line with policy objective, including the Government's focus on providing a boost to India Inc. and incentivizing globalization efforts. Several clarifications have to be provided in the draft rules including matters relating to burden of proof, hierarchy of tests, clarity on what is 'key management and commercial decisions', etc.

2. Replace POEM with CFC Rules: In order to tax passive income earned by overseas subsidiaries located in tax havens, India may consider introducing CFC rules with full credit for foreign taxes paid (directly or indirectly). Several countries that use place of incorporation as the criterion for residence, have CFC rules. This is also consistent with the OECD BEPS Action Plans.

3. Certainty: Foreign investors in Indian Alternative Investment Funds (AIFs) should be provided certainty by clarifying that the POEM rules would not apply provided there are no Indian tax residents as employees or directors of such Foreign Investors, based in India.

The above has to be viewed in context of the Government having recently liberalised the foreign direct investment norms around investment in Indian Alternate Investment Funds,

which is aimed at attracting additional foreign investment and promoting the domestic fund management industry. There is a need to carefully analyse the impact of the POEM guidelines so as to not undo the positive measures taken and not to jeopardize the Indian fund industry.

4. Board Meetings: For a company engaged in active business outside India, it may be again prudent to clarify that attending the Board of Directors meeting (being held outside India) through electronic means (Video/ Audio conferencing) from India, would not in any manner be construed as the board meeting being conducted in India.

5. POEM in India Only: The guidelines should be used only to determine POEM in India and not in other countries. The POEM guidelines have been issued with a stated intent for providing guidance to tax payers and tax administration in determining POEM of a company incorporated in a foreign jurisdiction. It would provide certainty if it is specifically clarified in the preamble to the guidelines that the guiding principles should be used by tax administration only to determine whether the foreign company has a POEM in India or not. These principles should not be used to determine POEM in other countries.

For example, if the POEM of a foreign company is outside India in a country other than its place of incorporation, the tax authorities should not deny benefit claimed by the foreign company under the Double Tax Avoidance Agreement between India and the country of incorporation of the foreign company.

6. Foreign Companies: POEM in case of foreign companies not engaged in active business outside India. As per para 8 of the guidelines, in case of foreign companies which are not engaged in active business outside India, the first step is to ascertain the person(s) who actually make the 'key management and commercial decisions' for conduct of the company's business as a whole and second step is to determine the place where these decisions are in fact being made. In this regard, various factors have been provided to determine the POEM.

However, the guidelines are not explicit enough on the relevance and hierarchy of the evaluation tests to be deployed. For example, there is no guidance on which decisions constitute 'key management and commercial decisions' and which decisions will meet the test of being relevant for the conduct of business as a whole. In absence of clarity on this critical point, it will be difficult to determine the POEM of investment holding companies which earn income in the nature of capital gains, dividend and interest.

Accordingly, without prejudice to the submission that test of residency for foreign companies should be based on place of incorporation, a separate set of guidelines may be issued to determine the POEM of foreign companies set-up to invest in India under the FPI, FDI or FVCI route.

We request you to consider the above and our members will be delighted to meet with you in person to explain the issues and recommendations in greater detail.

Thank you for kind consideration.

Arvind P. Mathur

Respectfully,

Arvind P. Mathur

President

Indian Private Equity & Venture Capital Association (IVCA)

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