

Residential Status & Scope of Income

There are two basic principles of International Taxation;

- ❖ Residence Based Taxation
- ❖ Source Based Taxation

Residence Based Taxation

- ❖ Natural persons or individuals - are taxable based on their **residence or domicile**, regardless of the source of income
- ❖ In case of companies, **the place of incorporation or the Place of Effective Management (POEM)** is its place of residence

Source Based Taxation

Income is taxed based **on its Source** regardless of the residence of the taxpayer

Residential Status & Scope of Total Income

Basic conditions: resident under 6(1)

- ❖ Must be present in India for a period of **182 days or more** during the previous year
- OR**
- ❖ Must be present in India for a period of **60 days or more** during the previous year AND aggregate period of stay should be **365 days or more in 4 immediately preceding previous years**

However, the second condition (ii) is not applicable in the following cases:

- ❖ An Indian citizen who leaves India during the previous year for the purpose of employment outside India or as a member of the crew of an Indian ship

- ❖ Indian citizen or person of Indian origin engaged outside India in an employment or a business or profession or in any other vocation, who comes on a visit to India in any previous year

Simple Illustration to Understand the Concept

Mathew Hayden, an Australian cricket player visits India for 100 days in every financial year from 2008-09 onward for his practice sessions. Find out his residential status for the assessment year 2018-19??

TIP

For the purpose of counting the number of days stayed in India, both the date of departure as well as the date of arrival are considered to be in India

Determination of Residential Status the A.Y. 2018-19

- Period of stay during previous year 2017-18 = 100 days: 1st condition NA
- Calculation of period of stay during 4 preceding previous years (100 x 4 = 400 days)
- Mr. Hayden has been in India for a period more than 60 days during previous year 2017-18 and for a period of more than 365 days during the 4 immediately preceding previous years

Therefore, since he satisfies one of the basic conditions under section 6(1), he is a resident for the assessment year 2018-19

Resident but Not Ordinarily Resident

A ordinarily resident person is one who satisfies **both** of the conditions specified under section 6 (6).

- ❖ His stay in India is **730 days or more for the last 7 years preceding the relevant previous year**

AND

- ❖ A resident in at least **2 out of 10 previous years** preceding the relevant previous year

(Both should be satisfied)

Again Hayden's illustration. Check whether he is a ROR/RNOR??

- ❖ Computation of period of stay during 7 preceding previous years = 100×7
= 700 days
- ❖ Since his period of stay in India during the past 7 previous years is less than 730 days, he is a Not-Ordinarily Resident during the assessment year 2018-19
- ❖ Therefore, Mr. Hayden is a Resident but Not-Ordinarily Resident during the previous year 2017-18 relevant to the assessment year 2018-19

i.e. **RNOR**

Residential Status of Firms HUF and Association of Persons

Resident in India if the **control and management** of its affairs is situated wholly or partly in India

Residential Status of Companies

With effect from Assessment year 2017-18, a company would be resident in India in any previous year, if

- ❖ It is an Indian Company

OR

- ❖ Its Place of Effective Management (POEM), in that year, is in India

What is POEM?

- ❖ “Place of Effective Management” to mean 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 [Explanation to section 6(3)]
- ❖ CBDT has issued a circular **No. 6/2017 dated 24 Jan 2017** on Guiding Principles for determination of Place of Effective Management of a Company

Whether Active Business Outside India (Business Test)

If yes;

- ❖ POEM outside India **provided** majority BOD meetings are held outside India
- ❖ If decision making authority **is not BOD** but Indian parent company or resident, POEM shall be in India

Companies Other than those Fulfilling the Test of ABOI

- ❖ Identification **of** persons who actually **make the key management and commercial decision** for conduct of the company's business as a whole.
- ❖ Determination of place where these decisions are, in fact, made.
- ❖ **If such a place is in India, then POEM is in India.**
- ❖ A company shall be said to be engaged in “Active Business Outside India” if **all of the following conditions** are satisfied by the company;
- ❖ If the passive income is not more than 50% of its total income **AND**
- ❖ Less than 50% of its total assets are situated in India **AND**
- ❖ Less than 50% of total number of employees are situated in India or are resident in India **AND**
- ❖ If the payroll expenses incurred on employees in India is less than 50% of its total payroll expenditure

What is Passive Income??

Passive income of a company shall be **aggregate of**

- ❖ Income from the transactions where both the purchase **and** sale of goods is from/to its associated enterprises

AND

- ❖ Income by way of royalty, dividend, capital gains, interest (except for banking company or public financial institution) or rental income

Illustration to Understand POEM

Example 1

Company A is a sourcing entity, for an Indian multinational group, incorporated in USA and is 100% subsidiary of Indian company (B Co.) [A Co. is a subsidiary of B Co.]. The warehouses and stock in them are the only assets of the company and are located in USA. All the employees of the company are also in USA. The average income wise breakup of the company's total income for three years is;

- 30% of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises
- 30% of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises
- 30% of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises
- 10% of the income is by way of interest

Answer:

In this case, passive income is **40%** of the total income of the company. The passive income consists of

- **30%** income from the transaction where both purchase and sale is from/to associated enterprises
- **10%** income from interest
- The A Co. satisfies the first requirement of the test of active business outside India
- Since no assets or employees of A Co. are in India the other requirements of the test is also satisfied
- Therefore, company is engaged in active business outside India

Example 2:

The other facts remain same as that in example 1 with the variation that A Co. has a total of 50 employees; 47 employees managing the warehouse, storekeeping and accounts of the company, are located in USA. The Managing Director (MD), Chief Executive Officer (CEO) and Sales Head are resident in India. The total annual payroll expenditure on these 50 employees is of ₹5 crore. The annual payroll expenditure in respect of MD, CEO and Sales Head is of ₹3 crore.

Answer:

- Although the first limb of active business test is satisfied by A Co. as only 40% of its total income is passive in nature
- Further, more than 50% of the employees are also situated outside India
- All the assets are situated outside India
- However, the payroll expenditure in respect of the MD, the CEO and the Sales Head being employees resident in India exceeds 50% of the total payroll expenditure
- Therefore, A Co. is not engaged in active business outside India

Example 3:

The basic facts are same as in example 1. Further facts are that all the directors of the A Co. are Indian residents. During the relevant previous year 5 meetings of the board of directors is held of which two were held in India and 3 outside India with two in USA and one in Canada.

Answer:

- The A Co. is engaged in active business outside India as the facts indicated in example 1 establish
- The majority of board meetings have been held outside India. Therefore, the POEM of A Co. shall be presumed to be outside India
- Directors residential status is irrelevant here

Example 4:

The facts are same as in example 3 but it is established by the assessing officer that although A Co.'s senior management team signs all the contracts. For all the contracts above ₹10 lakh the A Co. must submit its recommendation to B Co. and B Co. makes the decision whether or not the contract may be accepted. It is also seen that during the previous year more than 99% of the contracts are above ₹10 lakh and over past years also the same trend in respect of value contribution of contracts above ₹10 lakh is seen.

Answer:

- These facts suggest that the effective management of the A Co. may have been exercised by the parent company B Co.

- Therefore, POEM of a company may in such cases be not presumed to be outside India even though A Co. is engaged in active business outside India and majority of board meeting are held outside India.

Example 5:

An Indian multinational group has a local holding company, A Co., in USA. The A Co. also has 100% downstream subsidiaries B Co. and C Co. in USA and D Co. in Canada.

The A Co. has income only by way of dividend and interest from investments made in its subsidiaries.

The Place of Effective Management of A Co. is in India and is exercised by ultimate parent company of the group. The subsidiaries B, C and D are engaged in active business outside India. The meetings of board of director of B Co., C Co. and D Co. are held in USA and Canada respectively

Answer:

- Merely because the POEM of an intermediate holding company is in India, the POEM of its subsidiaries shall not be taken to be in India
- Each subsidiary has to be examined separately. As indicated in the facts since companies B Co., C Co., and D Co. are independently engaged in active business outside India and majority of board meetings of these companies are also held outside India
- The POEM of B Co., C Co., and D Co. shall be presumed to be outside India

Tips

- The concept of POEM is important to determine the residential status of a foreign company operating in India

- For example, a foreign company fulfilling the conditions of POEM will be deemed as Indian resident and the global income of such foreign company is taxable in India

Further, the CBDT vide Circular no. 8/2017 dated 23.02.2017 also clarified that POEM guidelines shall not apply to a company having turnover or gross receipts of **₹50 crores or less in a financial year**

Scope of Total Income Section 5

Resident and Ordinarily Resident

The total income of a resident assessee would, under section 5(1), consist of:

- Income **received or deemed to be received** in India during the previous year
- Income which **accrues** or is **deemed to accrue** in India during the previous year
- Income which **accrues or arises outside India** even if it is not received or brought into India during the previous year

Resident but Not Ordinarily Resident

- Under section 5(1), the **computation of total income** of Resident but Not-Ordinarily Resident (**RNOR**) is the **same** as in the case of Resident and Ordinarily Resident (**ROR**) stated above **except** for the fact that the **income accruing or arising to him outside India is not to be included** in his total income
- But if such income is derived **from a business controlled from or profession set up in India**, then it must be included in his total income even though it accrues or arises outside India

Non-Resident

A non-resident's total income under section 5(2) includes

- Income **received or deemed** to be received in India in the previous year
- Income which **accrues or is deemed** to accrue in India during the previous year

Income Deemed to Accrue or Arise in India [Section 9]

Any income accruing or arising to an assessee in any place outside India whether directly or indirectly

- Through or from any **business connection** in India
- Through or from any property in India
- Through or from any asset or source of income in India or
- Through the transfer of a capital asset situated in India

Would be deemed to accrue or arise in India. **[Section 9(1)(i)]**

Income from Salaries Earned in India [Section 9(1)(ii)]

- Income, which falls under the head "**Salaries,**" **deemed to accrue or arise in India, if it is earned in India.** Salary payable for service rendered in India would be treated as earned in India
- **Income from salaries payable by the government for services rendered outside India [section 9(1)(iii)]**
- Income from '**Salaries**' which is **payable by the government to a citizen of India for services rendered outside India** would be deemed to accrue or arise in India

TIP: However, allowances and perquisites paid outside India by the government is exempt, by virtue of section 10(7)

Dividend Paid by an Indian Company Outside India [Section 9(1)(iv)]

- ❖ All dividends paid by an Indian company must be deemed to accrue or arise in India
- ❖ Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is **payable by** –
 - The government
 - A person resident in India
 - A non-resident when it is payable in respect of moneys borrowed and used for **the purpose of a business or profession** carried on in India by him

Fees for Technical Services [section 9(1)(vii)]

Any fees for technical services will be deemed to accrue or arise in India if they are **payable by** –

- The government
- A person resident in India
- A non-resident only when the fees for Technical Service is utilized for purposes **of a business or profession** carried on in India **or** for the purposes of **making any income from any source in India**