

ITAT Delhi examines Principal Purpose Test and allows the benefit under India-Luxembourg Tax Treaty

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Introduction

In a first of its kind ruling, the Delhi bench of the Income Tax Appellate Tribunal (ITAT) in the case of SC Lowy P.I. (LUX) S.A.R.L. vs. ACIT, (ITA No.3568/DEL/2023) has adjudicated on the merits of the PPT provisions and in the facts, granted the benefit under the double taxation avoidance agreement (Tax Treaty) between India and Luxembourg with respect to income earned by a Luxembourg company (Taxpayer) from its India investments.

Principal Purpose Test | Setting the context

The Principal Purpose Test (PPT) is a provision included in Tax Treaties between countries that have signed and ratified the '*Multilateral Instrument*' (MLI), an action plan introduced by Organisation for Economic Co-operation and Development to address tax avoidance in cross border arrangements. Accordingly, PPT seeks to deny the Tax Treaty benefits in cases where any of the principal purposes of the concerned arrangement / transaction was to obtain such tax benefit, unless providing such benefit is in accordance with the object and purpose of the relevant provision of the Tax Treaty.

Background

The Taxpayer was incorporated in Luxembourg, as a step-down subsidiary of a Cayman Islands entity, to pool in funds from the investors and invest in portfolio across the globe.

The Taxpayer was also registered as a Foreign Portfolio Investor with the Securities Exchange Board of India and invested in various asset-classes in India (including debentures, bonds, units of alternative investment funds (AIF) and securitization trust).

Notably, the India investments comprised approximately 14% of the overall portfolio of the Taxpayer and 86% of the investments were made in jurisdictions other than India. During the year under consideration, the Taxpayer's income comprised of inter-alia (a) business income from securitization trust (b) capital gain on sale of debentures and bonds; and (c) interest income from participation in AIF.

As the Taxpayer was a tax resident of Luxembourg and held a valid tax residency certificate (TRC), it claimed an exemption from tax in India under India-Luxembourg Tax Treaty on the business income and capital gain on sale of debentures and bonds; and offered the interest income earned from participation in AIF to tax in India at the concessional rate of 10% under the India-Luxembourg Tax Treaty.

However, the tax authorities denied benefits under the India-Luxembourg Tax Treaty on account of the following reasons:

- (a) The Taxpayer has adopted treaty shopping mechanism to claim the Tax Treaty benefit (i.e. the Taxpayer was set up in Luxembourg by its Cayman based holding company for the purpose of obtaining a benefit under the India-Luxembourg Tax Treaty)

- (b) Taxpayer was a conduit and not the beneficial owner of the income earned from India investments.
- (c) Setting up of Taxpayer in Luxembourg lacks commercial rationale.
- (d) Taxpayer did not incur any expenditure in Luxembourg.

Accordingly, the tax authorities invoked PPT provisions and alleged that the principal purpose of setting up the Taxpayer in Luxembourg was to claim Tax Treaty benefits.

Aggrieved, the Taxpayer filed its objections before the Dispute Resolution Panel (DRP), which affirmed the order of tax officer. Against the order of the DRP, the Taxpayer filed an appeal before the ITAT:

ITAT Ruling

The ITAT ruled in favour of Taxpayer and held that the Taxpayer is a resident of Luxembourg and eligible to claim benefits under the India-Luxembourg Tax Treaty. Key factors and observations noted by ITAT are as set out below:

- **Tax residency:**

Relying on the Delhi High Court ruling in the case of *Tiger Global*, [2024] 165 taxmann.com 850 (Delhi) (Please see our earlier [Ergo](#) on the ruling), ITAT noted that tax authorities have not brought on record any cogent evidence to prove that Taxpayer is a conduit or the transaction is illegal or sham or involves a tax fraud and hence, TRC held by the Taxpayer is sufficient to demonstrate that the Taxpayer is a resident of Luxembourg and is entitled to Tax Treaty benefits.

- **Purpose:**

Taxpayer was incorporated in Luxembourg in the year 2015 as an investment holding company much before to the introduction of PPT in the Tax Treaty. The Taxpayer was set up as a special purpose vehicle to pool in funds from investors and primarily to invest in distressed assets across varied jurisdictions (such as Europe, United Kingdom, India, and Italy).

- **Substance:**

In terms of geographical bifurcation, 86% of the investments were made by the Taxpayer outside India. The Taxpayer incurred substantial operational expenditure pertaining to its investments in Luxembourg in the nature of consulting fees, legal and litigation fees, administrative expenses such as rent, bank account charges, accounting fees, etc. The Taxpayer filed its tax return and paid applicable taxes in Luxembourg on income earned from India as well as other jurisdictions. The Taxpayer continued to exist and hold substantial investments.

- **Beneficial Ownership:**

Taxpayer made the investments on its own account by utilizing the funds raised by issue of capital and share warrants. Taxpayer had no obligation to pass on the income to its parent entity and the income earned from India investments was not repatriated to the Cayman Islands parent entity. As a result, the Taxpayer was the legal and beneficial owner of the income.

Having concluded that the Taxpayer was eligible to claim the benefit under India-Luxembourg Tax Treaty, the position adopted by the Taxpayer with respect to non-taxability of income earned from pass through certificates in securitization trusts and capital gain on transfer of bonds and debentures as well as interest income being taxable at the concessional rate of 10% was accepted by the ITAT.

Comments

Eligibility to Tax Treaty benefits has been a subject matter of extensive litigation in India. The Central Board of Direct Taxes and the Indian courts have consistently affirmed TRC as a valid proof of residency and beneficial ownership. Nonetheless, the tax authorities continue to examine investment structures involving Tax Treaty benefits based on a substance over form approach. With the introduction of PPT under the

applicable Tax Treaties and General Anti-Avoidance Rules (GAAR) under Indian domestic tax law, demonstrating commercial rationale and substance in the underlying structure is one of the key considerations to avail Tax Treaty benefits.

Considering that PPT is at a nascent stage, the ITAT ruling is a shot in the arm which adopts a balanced approach by taking cognizance of the structure and activities of the Taxpayer and shifting the burden of proof on the tax authorities in support of its allegation that principal purpose of Taxpayer being set up in Luxembourg was to claim the India-Luxembourg Tax Treaty benefit.

The purpose of setting up in Luxembourg, the fact of Taxpayer's investments in other jurisdictions being significantly higher than India investments and the Taxpayer having incurred substantial operational expenditure was considered sufficient by ITAT for the Taxpayer to meet the PPT test. This ruling should assist the Taxpayers with similar facts and circumstances to navigate the intricacies relating to PPT and assess their eligibility to claim Tax Treaty benefits.

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