ERGO

KHAITAN & CO ADVOCATES SINCE 1911

Government issues guidance on application of 'principal purpose test' under tax treaties

24 January 2025

In a welcome move, the apex tax administration body in India, the Central Board of Direct Taxes (CBDT) has clarified vide Circular No. 1 of 2025 (Circular) that (i) the 'Principal Purpose Test' (PPT) under tax treaties shall apply prospectively; and (ii) in case of shares acquired by residents of Mauritius, Cyprus, and Singapore in Indian companies prior to 1 April 2017 (Grandfathered Shares), the gains on transfer of such shares will remain outside the purview of the PPT. The Circular dispels concerns regarding the application of PPT on Grandfathered Shares and provides much-needed clarity, reducing uncertainties and the likelihood of disputes.

Introduction

PPT has been introduced as an anti-abuse rule under the tax treaties which are amended by the 'Multilateral Instrument' (MLI) (such as India's tax treaties with Singapore, Netherlands, Cyprus); or through bilateral negotiations between India and certain other jurisdictions (such as China, Hong Kong, Chile). Interestingly, the India Mauritius tax treaty is not covered by the MLI, however, the Indian and the Mauritian governments had signed a protocol on 7 March 2024 to amend the India – Mauritius tax treaty and introduce PPT provisions into the treaty. The protocol has, however, not been notified and is not effective as on date.

The core objective of introducing the PPT in tax treaties is to prevent misuse of treaty provisions where one of the principal purposes of an arrangement or a transaction is to obtain treaty benefits. However, these benefits may still be granted if it can be demonstrated that they align with the intent and purpose of the relevant provisions of the tax treaty.

Pertinently, India's tax treaties with Singapore, Cyprus and Mauritius provide a capital gains exemption on sale of Grandfathered Shares and gains on sale of such shares are also not subject to the domestic general anti abuse rules (GAAR). However, the PPT provisions do not exclude the sale of Grandfathered Shares. This creates uncertainty regarding taxpayers' ability to rely on the capital gains tax exemption under the relevant treaties despite express grandfathering benefit under these tax treaties and domestic anti abuse rules. The government has issued a welcome clarification in this regard, as discussed below.

CBDT clarification

The Circular clarifies that bilateral commitments made by India under tax treaties with Singapore, Mauritius, and Cyprus to exempt capital gains on transfer of Grandfathered Shares will remain outside the purview of the PPT provisions.

Further, with an intention to provide parity and uniformity in application of the PPT provisions, the Circular clarifies a prospective application of PPT as under:

1. **PPT incorporated in tax treaties on account of bilateral negotiations**: From the date of entry into force of the tax treaty or the amending protocol introducing the PPT provisions (as the case may be).

2. **PPT incorporated in tax treaties on account of MLI**: From the date of 'entry into effect' of the provisions of MLI with respect to the relevant treaty.

Comments

With the introduction of PPT under the relevant tax treaties, substantiating 'commercial rationale' and 'substance' in structures is one of the key requisites to avail a tax treaty benefit. The Circular alludes to the fact that analysis of the PPT provisions is a context driven fact-based exercise to be caried out on a case-by-case basis, indicating that there are no defined set of parameters to test it. Recently, in one of the first decisions involving interpretation of PPT provisions under India's tax treaties, the Delhi bench of the Income Tax Appellate Tribunal in the case of *SC Lowy PI (LUX) SARL v ACIT* ITA No.3568/DEL/2023 granted the benefit of the India – Luxembourg tax treaty to income earned by a Luxembourg company from its India investments based on favorable facts such as diversification of investments by the investor, substantial expenses incurred by the investor in the home jurisdiction, existence since over a decade, etc. Notably, the PPT rules introduced pursuant to the MLI provisions do not apply to deny the benefit of a tax treaty in case obtaining the benefit was in accordance with the 'object and purpose' of the relevant provisions of the tax treaty - the Circular is, however, silent on how to ascertain the 'object and purpose' of the tax treaty and hence interpretational ambiguities may be expected on this front.

The clarification that PPT would not apply to the transfer of Grandfathered Shares is welcome as such transactions would be subject to neither PPT nor GAAR. Regarding the prospective application of PPT, while the position was clear (except the protocol dated 7 March 2024 to the Indian – Mauritius tax treaty which created certain ambiguities), it does provide absolute clarity that PPT would not be applied retrospectively to past transactions or events.

Notably, the grandfathering provisions are introduced in the respective treaties only with respect to 'capital gains' on shares and not to any other types of income. Therefore, other income such as dividends on shares (regardless of whether the shares are Grandfathered Shares or not), or gains on sale of debentures or on an indirect transfer of Indian assets would continue to be subject to the PPT test (on a prospective basis).

Further, the benefit of grandfathering under the India-Singapore tax treaty is contingent upon tax payer meeting specific conditions such as it not being a shell/conduit company and compliance with minimum expenditure requirements. The specific conditions deny the capital gains tax benefit if arrangements are made with the 'primary purpose' of obtaining that benefit, which is narrower than the PPT's 'one of the primary purposes' criterion. Hence, even after the clarification under the Circular, taxpayers must still comply with such specific conditions to claim a tax treaty benefit.

The CBDT guidance on the PPT provisions is non-controversial and a positive/ reassuring step for the stakeholders to boost investor confidence.

- *Sanjay Sanghvi (Partner); Ritu Shaktawat (Partner) and Viraj Doshi (Principal Associate)*

About Khaitan & Co

Khaitan & Co is a top tier and full-service law firm with over 1200 legal professionals, including 270+ leaders and presence in India and Singapore. With more than a century of experience in practicing law, we offer end-to-end legal solutions in diverse practice areas to our clients across the world. We have a team of highly motivated and dynamic professionals delivering outstanding client service and expert legal advice across a wide gamut of sectors and industries.

To know more, visit **www.khaitanco.com**

This document has been created for informational purposes only. Neither Khaitan & Co nor any of its partners, associates or allied professionals shall be liable for any interpretation or accuracy of the information contained herein, including any errors or incompleteness. This document is intended for non-commercial use and for the general consumption of the reader, and should not be considered as legal advice or legal opinion of any form and may not be relied upon by any person for such purpose. It may not be quoted or referred to in any public document, or shown to, or filed with any government authority, agency or other official body.

www.khaitanco.com | © Khaitan & Co 2024 | All Rights Reserved.