

EY Tax Alert

CBDT issues guidance on application of Principal Purpose Test

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Executive summary

This Tax Alert summarizes a recent Circular No. 01/2025 dated 21 January 2025¹ (Circular) issued by the Central Board of Direct Taxes (CBDT)² providing guidance on application of the Principal Purpose Test (PPT) provisions in the context of Indian tax treaties.

Broadly, the Circular clarifies that PPT provisions are to be applied prospectively from (i) the date of entry into force of the treaty/amending protocol whereby PPT was introduced pursuant to bilateral negotiations; or (ii) the effective date of provisions introducing PPT into the treaty through Multilateral Instrument (MLI).

Further, it also clarifies that grandfathering benefit with reference to capital gains arising from transfer of shares of an Indian company by treaty residents of Mauritius, Singapore and Cyprus in respect of shares acquired prior to 1 April 2017 will be outside the purview of PPT and instead be governed by specific provisions of the respective tax treaty.

¹ The instant alert is based on English version of the Circular published by TaxSutra on 22 January 2025. Any conflict with the Hindi version will need to be separately evaluated in light of existing constitutional principles around precedence of a particular language in legal interpretations illustratively, Park Leather Industry (P) Ltd. and another v. State of U.P. and others [(2001) 3 SCC 135].

² The apex body for administration of direct taxes in India



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Background

PPT and India's tax treaties

- ▶ PPT is one of the key measures of the Base Erosion and Profit Shifting (BEPS 1.0) project of the Organisation for Economic Co-operation and Development (OECD) to combat treaty abuse/shopping.
- ▶ Broadly, PPT acts as a means to deny treaty benefits if one of the principal purposes of the arrangement or transaction is to obtain the treaty benefit, unless granting said treaty benefit is in accordance with the object and purpose of the tax treaty.
- ▶ As part of BEPS 1.0, PPT was implemented globally through an MLI which was signed in 2017 by various countries including India. Further, MLI was ratified by India in 2019³.
- ▶ The provisions of MLI entered into force for various countries on different dates depending upon the date of ratification of MLI. For India, the MLI entered into force on 1 October 2019 being the first day of the month after expiry of three months from date of deposition of ratification instrument by India with OECD (25 June 2019).
- ▶ Further, once MLI has come into force, the effective date of MLI is determined based on the later⁴ of the dates of coming into force of treaty under consideration (Relevant Date).
- ▶ Broadly, as per the MLI, the date of entry into effect is as under:

Particulars	Date of entry into effect
For withholding taxes (WHT)	1 st day of next taxable period that begins on or after the Relevant Date
For other taxes	Taxable period that begins on or after expiry of six calendar months from the Relevant Date

- ▶ Separately, PPT provisions have also been inserted through bilateral negotiations (i) in recent treaties entered into by India (illustratively Hong Kong, Chile, etc.); or (ii) in certain existing treaties vide amending protocols (illustratively, China, etc.)

Capital Gains Grandfathering under Indian Tax Treaties

- ▶ Mauritius, Singapore and Cyprus have been the preferred holding company jurisdictions (HCJs) for investments into India for varied reasons.
- ▶ Historically, India's treaties with these HCJs assign capital gains taxation rights to the resident country. In line with India's treaty policy to prevent double non-taxation, curb revenue losses as also to check black money, w.e.f. 1 April 2017, India bilaterally negotiated the respective treaties wherein taxation rights with respect to capital gains on sale of shares acquired on or after 1 April 2017 was also provided to the source country. Accordingly, the earlier acquisition, i.e. those prior to 1 April 2017 were grandfathered [i.e. only the resident country has exclusive right to tax gains on alienation of grandfathered shares (Grandfathering Provisions)] to continue with exclusive source taxation right to country of residence.
- ▶ Pursuant to MLI, India's treaties with Singapore and Cyprus have been modified to include PPT provision. While treaty with Mauritius was not amended pursuant to MLI, it was agreed to change the treaty in line with BEPS 1.0 object through bilateral discussions.
- ▶ In March 2024, both India and Mauritius signed a protocol to amend the India-Mauritius treaty to insert PPT. The protocol is however yet to come⁵.

Circular in brief

In order to provide certainty and clarity on application of PPT provisions, CBDT, vide Circular No. 01/2025 dated 21 January 2025 (Circular), has laid down below guidance on application of PPT under India's tax treaties:

General Principles on Application of PPT

- ▶ PPT seeks to curb revenue leakage by preventing treaty abuse to ensure that treaty benefits are available in respect of '*bonafide exchange of goods and services, and movement of capital and persons*'.
- ▶ PPT evaluation is based on objective assessment of relevant facts and circumstances and results in '*context-specific fact-based exercise, to be carried out on a case-by-case basis*'.
- ▶ BEPS Action Plan 6 Final Report⁶ and the Commentary on Articles 1⁷ and 29⁸ of the UN Model Tax Convention (updated in 2021) are additional/supplementary sources of guidance

³ Refer EY Tax Alert "India deposits Multilateral instrument with OECD to modify bilateral tax treaties under MLI" dated 27 June 2019

⁴ This may be determined from OECD's BEPS MLI Matching Database available at: <https://www.oecd.org/en/data/tools/beps-ml-matching-database.html>

⁵ Refer EY tax alert "Protocol to India-Mauritius DTAA signed to include Principal Purpose Test" dated 15 April 2024

⁶ A report by OECD which recommends introduction of PPT as a mechanism of addressing treaty abuse.

⁷ Pertaining to "Persons Covered"

⁸ Pertaining to "Entitlement of Benefits"

relevant for invocation and application of PPT (subject to India's reservations thereon⁹).

Prospective Application of PPT

- The Circular clarifies that PPT provision is intended to be applied prospectively i.e. as and when the PPT provisions are effective in the treaty as below:
 - With reference to treaties entered into bilaterally to include PPT provisions (say Iran, Hong Kong), PPT will apply from the date of entry into force of the respective treaty.
 - Where PPT provision is included bilaterally by way of amending protocol (say China) PPT will apply from the date of entry into force of the respective amending protocol.
 - With reference to treaties wherein PPT is incorporated pursuant to MLI, PPT will apply from the date of entry into effect of the provisions of the MLI with respective treaties.

Impact of PPT on Grandfathering Provisions under treaties with HCJs

- The Circular addresses the ambiguity on applicability of PPT to Grandfathering Provisions of India's treaties with HCJs and provides that the specific grandfathering bilateral commitment are outside the purview of PPT.
- Circular also clarifies that while PPT will not be applicable, specific provisions agreed in the respective treaties, if any, say illustratively Limitation of Benefits (LOB) clause under India-Singapore tax treaty, shall continue to apply.

Comments

The guidance from CBDT on application of PPT provisions is a welcome move as it provides certainty on tax implications to foreign investors who have invested in India in the past. The CBDT Circular also makes it clear that PPT provisions will apply only after their entry into force as per applicable bilateral/ multilateral agreement.

With this CBDT clarification, treaty residents of Mauritius, Singapore and Cyprus can continue to enjoy grandfathering benefit having regard to guidelines provided by the Supreme Court decisions in the cases of Azadi Bachao Andolan¹⁰, Vodafone International Holdings B.V.¹¹ and Delhi High Court decision in the case of Tiger Global International III Holdings¹².

It may be also noted that General Anti-Avoidance Rules (GAAR) provisions under the Indian domestic laws also grandfather income arising from transfer of investments made before the 1 April 2017.

As noted above, India's treaty with Cyprus and Singapore have already implemented PPT through MLI, while the 2024 Protocol, proposed to insert PPT in India-Mauritius tax treaty, has not yet been entered into force.

In this context, it is noteworthy that the UN and OECD Commentaries on Article 29 talk about the possibility of applying PPT only after approval by senior officials of the tax administration in a similar form to application of GAAR provisions. However, no reference is made in this regard by the Circular.

With the MLI now effective with the majority of India's treaty partners, the PPT provisions have already become applicable across a broad spectrum of international tax agreements. This recent guidance from the CBDT is set to assist businesses in understanding and navigating the impact of PPT on their cross-border transactions and, thus, need careful evaluation for various transactions undertaken.

^[10] [2003] 263 ITR 706 (SC)

^[11] [2012] 341 ITR 1 (SC)

^[12] [TS-624-HC-2024(DEL)]

⁹ As on date, India has currently not expressed any reservations to BEPS Action Plan 6 Final Report or

Commentary on Articles 1 and 29 of the UN Model Tax Convention (updated in 2021) with respect to PPT

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