

CBDT issues guidelines for application of Principal Purpose Test (PPT)

The Indian government has issued a clarification on 21 January'25 with respect to the application of Principal Purpose Test ("PPT") vide the attached Circular. As you would be aware, PPT provision aims to tackle treaty abuse including treaty shopping. PPT seeks to deny tax treaty benefits in cases where one of the principal purposes of the concerned arrangement / transaction is to obtain tax benefit, unless providing such benefit is in accordance with the object and purpose of the relevant provision of the tax treaty.

We have summarized below the key clarifications provided on applicability of PPT:

Interplay of PPT with grandfathering provisions under tax treaties (India-Cyprus, India-Mauritius and India-Singapore):

- Certain grandfathering provisions have been provided under tax treaties (i.e., India-Cyprus, India-Mauritius and India-Singapore). It has been clarified that such grandfathering provisions shall be outside the purview of the PPT. Accordingly, for US headquartered companies routing their investments through group entities in jurisdictions like Cyprus, Singapore and Mauritius, this is a welcome development as PPT provisions will not be applicable on grandfathered investments (i.e., investments made prior to 01 April 2017).

Period for which PPT applies:

- It is clarified that PPT provision is intended to be applied prospectively.
- For tax treaties where PPT has been incorporated through bilateral processes, PPT shall be applicable from the date of entry into force of the tax treaty or amending protocol (e.g., most recently India-Mauritius tax treaty amended to include PPT – yet to be notified).
- For tax treaties where the PPT has been incorporated through Multilateral Instrument ("MLI"), PPT shall be applicable from the date of entry into effect of the provisions of the MLI (as per the dates specified for withholding taxes and other taxes in the respective tax treaty).

Additional guidance:

- The Circular re-emphasizes that application of PPT shall be a context-specific fact-based exercise, to be carried out on a case-to-case basis keeping in view the objective facts and findings.
- Tax authorities may refer to BEPS Action Plan 6 Final report and Commentary to Article 1 and 29 of the UN Model Tax Convention as additional and supplementary sources of guidance while examining PPT.

The circular broadens the ability of the tax authorities to carry out a detailed examination and not solely rely on the Tax Residency Certificate for granting treaty benefits. Accordingly, for demonstrating PPT, it is crucial that taxpayers maintain adequate documentation to substantiate purpose of the transaction and commercial substance while availing treaty benefits.

Key impact areas:

If you consider the India – Mauritius tax treaty, a protocol amending the tax treaty was signed by the Indian and Mauritius Governments on 7 March 2024 (the text of which has been made public in April 2024) to include PPT provisions within the tax treaty. While the protocol has not yet been notified, the clarification provided by the CBDT states that PPT provisions will apply only for transactions that will be undertaken post the protocol being notified i.e., to the following transactions:

- Investments made on or after notification of the protocol; or
- Sale of investments on or after notification of the protocol (subject to the ‘Grandfathering provisions’ clarified below); or
- Other income (dividend, interest, etc.) received on or after notification of the protocol.

We have summarized illustrative scenarios for reference:

| India’s Treaties | Transaction | Impact |
|--|---|---|
| Mauritius*/ Cyprus/ Singapore | Sale of shares acquired / invested prior to amendment to tax treaties | Transaction shall remain outside the purview of PPT on account of grandfathering commitment under respective tax treaty |
| | Other transactions | PPT applies from the date of entry into force of the DTAA or the Amending Protocol (unless covered by grandfathering provision of the tax treaty) |
| PPT incorporated through bilateral process (Chile, Iran, Hong Kong, China etc.) | All transactions | PPT applies from the date of entry into force of the DTAA or the Amending Protocol |
| Other tax treaties where the PPT has been incorporated through the Multilateral Instrument | All transactions | PPT applies from the date specified in Article 35 of the MLI with respect to taxes withheld at source and with respect to other taxes |

***It is pertinent to note that at once the Protocol is actually notified, the Government may issue additional guidance/ clarification on the applicability of PPT specifically for the transactions covered under the India – Mauritius DTAA. The above views will then be subject to any such additional guidance/ clarification which may be issued.**

The clarification provided by CBDT with respect to date of application of PPT provisions and giving pre-eminence to the grandfathering provisions under the tax treaties with Cyprus, Mauritius, and Singapore to be out of the purview of PPT framework has provided the required certainty to investors.

Positive Takeaways –

To re-iterate benefits to investors, the guidance clarifies that the denial of treaty benefit isn't a matter of subjective satisfaction of the revenue - limiting revenue's discretion. The invocation of PPT must be based on "objective assessment of relevant facts". Given that India legislated GAAR in 2017, investors feared retrospective application of PPT standards. Dispelling this fear, the guidance, besides clarifying the PPT's prospective application, sets out specific illustrations on the date of application.

The guidance further posits with respect to key foreign direct investment destinations, namely Cyprus, Mauritius, and Singapore, to clarify that the PPT cannot overcome grandfathering provisions under these treaties. To this end, the guidance reaffirms the importance of bilateral protocols between India and its counterparts. This reassurance obviates the scope of interpretation by tax officers, which, though often overridden by judicial proceedings, upend years of efforts to address investor anxieties. It is now judicially settled that instructions of the CBDT draw upon its statutory empowerment binding upon tax officers and create an enforceable legal right for taxpayers. The guidance is, therefore, a proactive measure to promote tax certainty and quell interpretative disputes.

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