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Introduction

India is a signatory to the Multilateral Convention to Implement Tax Treaty Related Provisions to Prevent Base Erosion and Profit Shifting (“**MLI**”). The MLI modifies the tax treaties covered under its ambit in several important ways.

A key change was the introduction of the principal purpose test (“**PPT**”), which denies a treaty benefit when obtaining that benefit was “**one of the principal purposes**” of any arrangement or transaction that resulted in that benefit being granted.

This can be seen to be a broader test compared to India’s General Anti-Avoidance Rule (“**GAAR**”), which specifically targets arrangements where *the* principal purpose is to obtain a tax benefit. Under Indian law, the provisions of the Income Tax Act, 1961 (“**ITA**”) apply only to the extent it is more favorable than tax treaties entered into by India.

Tax Treaties entered into by India generally provide additional relief, either through reduced rate of tax or through revised allocation of taxing rights and therefore, any denial of treaty benefits can cause significant tax burden for taxpayers.

Current Practice in Tax Treaty Cases

The MLI came into effect for India on October 1, 2019. Since then, there has been little administrative guidance from India’s tax authorities (“**ITD**”) regarding the practical application of the PPT. Nevertheless, in some cases, the ITD has denied treaty benefits by indiscriminately applying the PPT, without considering whether granting the benefit claimed would be in accordance with the “**object and purpose**” of the tax treaty – an exception that is built-in to the PPT.

In a recent decision¹, the Income Tax Appellate Tribunal (“**ITAT**”) disapproved of this approach, observing that the ITD could not deny treaty benefits without bringing on record “**cogent and convincing evidence**” to prove that an arrangement was entered into only for the purpose of taking treaty benefits.

Guidance on applying the PPT

The Central Board of Direct Taxes (“**CBDT**”) has issued a

¹ SC Lowy P.I. (Lux) S.A.R.L. v. ACIT, order dated 30.12.2024 in ITA No. 3568/Del/2023.

Circular² on 21 January 2025 providing “**guidance**” for applying the PPT. The Circular states that:

- ▶ the PPT is intended to ensure that tax treaty benefits are only granted for *bona fide* exchange of goods and services, and movement of capital and persons;
- ▶ the application of the PPT will be based on an “**objective assessment**” of the “**relevant facts and circumstances**”, and will be a “**context specific fact-based exercise**”; keeping in view “**objective facts and findings**”
- ▶ the onus is on the taxpayer to establish that granting a tax treaty benefit would be in accordance with the “**object and purpose**” of the treaty
- ▶ the PPT will only apply prospectively i.e., from the date of entry into force of the tax treaty;
- ▶ provision incorporating the PPT (where bilaterally negotiated), or from the date from which the MLI takes effect with respect to the tax treaty;
- ▶ treaty-specific bilateral commitments in the form of grandfathering provisions (under India’s tax treaties with Mauritius, Singapore, and Cyprus) will not be covered by the PPT, but by the specific provisions of those treaties;
- ▶ subject to India’s reservations, the ITD may rely on the BEPS Action Plan 6 Final Report and the Commentary to Articles 1 and 29 of the UN Model Tax Convention (2021) (“**UN MTC**”) as additional/supplementary sources of guidance while deciding on the application of the PPT.

Why the Circular matters

The Circular establishes a significant foundation for the future application of the PPT. The fact that it is only intended to apply prospectively, and that it will not affect *bona fide* grandfathered structures, are crucial clarifications, as such structures continue to face increased scrutiny from the ITD at the time of exit/unwinding over alleged lack of beneficial ownership of income or assets, or “**economic substance**”.

As circulars issued by the CBDT are binding on the ITD³, this Circular is expected to result in a more discerning approach in tax treaty cases involving such structures in the future.

At the same time, a number of points in the Circular call for further consideration:

- ▶ The Circular does not explain what facts and circumstances will be considered “**relevant**” when applying the PPT. Even though Indian courts have repeatedly stated that the ITD can look beyond a tax residency certificate (“**TRC**”) in very limited circumstances, based on the ITD’s recent approach in tax treaty cases, all facts relating to the taxpayer including its ownership, management, decision making, and the level of its “**substance**” in its home jurisdiction, the nature and source of its funding, the extent of its beneficial ownership over the

² Circular No. 01/2025 dated 21 January 2025, F. No. 500/05/2020/FT&TR-II.

³ *Navnit Lal C Javeri v. KK Sen*, [1965] 56 ITR 198 (SC); *Keshavji Ravji & Co v. CIT*, [1990] 183 ITR 1 (SC); and *Union of India v. Azadi Bachao Andolan*, [2003] 263 ITR 706 (SC).

income derived, and the usage and application of that income are all likely to be considered “**relevant**” when determining a treaty benefit claim.

- ▶ The Circular makes it clear that once the ITD determines that obtaining a tax benefit was one of the principal purposes of a transaction or arrangement, the onus is on the taxpayer to establish that granting that benefit would be in accordance with the “**object and purpose**” of the “**relevant provisions**” of the treaty. In the first place, there is a clear shift that the burden of proof is on the tax payer to show why the treaty benefit should apply, once the tax authorities make their basic determination that tax benefit was one of the principal purpose of the transaction. Second, it is unclear what the “**relevant provisions**” are to test the “**object and purpose**”. Do they relate to the “**object and purpose**” of the treaty as a whole, or only the treaty provision establishing the benefit? This is particularly important since the MLI *also* introduces preamble language clarifying that a tax treaty is not intended to create opportunities for non-taxation or reduced taxation through tax avoidance. The Circular appears to favour the former interpretation since it specifically states that tax treaty benefits are only granted for *bona fide* exchange of goods and services, and movement of capital and persons.
- ▶ While India’s tax treaties with Singapore and Cyprus have been modified by the MLI to include the PPT, the 2024 Protocol incorporating the PPT in the India-Mauritius tax treaty is yet to be ratified or notified by India. The ITAT has already ruled that the PPT under that treaty would not be applicable until the notification process is completed.⁴
- ▶ Authorizing the ITD to rely on the BEPS Action 6 Final Report and the Commentary to Articles 1 and 29 of the UN MTC is likely to lead to mixed results. On the one hand, both sources set out clear(er) benchmarks for determining situations where tax scrutiny would be justified, which *should* (in theory) boost fairness and provide certainty in the tax audit process. On the other hand, both sources contain a number of controversial observations and “**examples**” that are highly likely (in practice) to create interpretative challenges that can only be resolved (if at all) through contentious proceedings.
- ▶ The Circular does not address the ITD’s increasing tendency to “**read in**” substance/beneficial ownership tests into tax treaty provisions that are not qualified by such requirements. This means that even in cases involving grandfathered situations (such as under India’s tax treaties with Mauritius or Singapore), the ITD may still apply judicial anti-abuse principles or “**substance**” requirements to deny tax treaty benefits. However, it should be noted that Indian courts have repeatedly set a fairly high bar for denying treaty benefits in such cases.

Looking Ahead

The Circular provides indicative guidance on how the ITD views the PPT. It appears that when applying the PPT, the ITD will evaluate whether arrangements align with the tax treaty’s fundamental purpose – facilitating genuine trade, services, and capital flows. Having said that, the Circular would have been more effective had it included specific examples and clear criteria for when the PPT would not apply, rather than

⁴ *ACIT v. Maven India Fund*, order dated 23.07.2024 in ITA No. 1766/Del/2023.

leaving decisions to a case-by-case interpretation.


Without compelling justification, taxpayers who lack sufficient “**substance**” or derive capital from third-country sources may face denials of treaty benefits under the PPT. This will likely spark significant litigation until courts establish clear legal principles on the PPT’s application.

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