TAX TREATIES AND THE PRINCIPAL PURPOSE TEST – GOVERNMENT CLARIFIES ITS APPLICATION

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Introduction

The Multilateral Convention to Implement Tax Treaty Related Provisions to Prevent Base Erosion and Profit Shifting ("**MLI**") to which India is a party materially modifies the tax treaties within its ambit. A key change introduced through the MLI was the introduction of *the* principal purpose test ("**PPT**"), which denies a treaty benefit when "***one of the principal purposes***" of any arrangement or transaction was to avail the treaty benefit. The ambit of PPT is wider as compared to India's General Anti-Avoidance Rule ("**GAAR**"), which only targets arrangements where the principal purpose is to obtain a tax benefit. Under Indian law, tax treaties override the Income-tax Act, 1961 ("**ITA**") to the extent such tax treaties are more favourable to the taxpayer. Any denial of treaty benefits using the PPT can thus cause significant tax burden for taxpayers.

Current Practice in Tax Treaty Cases

The MLI came into effect for India on October 1, 2019. It currently covers 65 of India's tax treaties, including treaties with the Netherlands, France, Luxembourg, Ireland, Singapore, the UAE, and the UK. Since then, there has been no administrative guidance from Indian income tax department ("**ITD**") regarding the application of the PPT. Nevertheless, in some cases, the ITD had denied treaty benefits by 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 *SC Lowy P.I. (Lux) S.A.R.L. v. ACIT*[1], the Income Tax Appellate Tribunal ("**ITAT**") recently 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 sole purpose of availing treaty benefits.

Guidance on applying the PPT

The Central Board of Direct Taxes ("**CBDT**") has issued a Circular[2] 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;

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1 Order dated 30.12.2024 in ITA No. 3568/Del/2023.

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

- 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; and
- 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 acts as a foundation for the principles on which the PPT would be applied. The fact that it is only intended to apply prospectively, and that it will not affect *bona fide* grandfathered transactions (i.e., those set up prior to April 1, 2017), are crucial clarifications, as such transactions 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***" being in the relevant treaty jurisdiction.

At the same time, several points in the Circular require further consideration:

- The Circular does not explain the facts and circumstances that will be considered "***relevant***" when applying the PPT. Even though Indian courts have reiterated that the ITD can look beyond a tax residency certificate ("**TRC**") in limited circumstances, based on the ITD's recent approach in tax treaty cases, there is significant likelihood that the Circular would legitimatize the approach of the ITD to examine several factors relating to the taxpayer including its ownership, management, decision making, the level of its "***substance***" in its home jurisdiction, the nature and source of its funding, the extent of its beneficial ownership over the income derived, and the usage and application of that income when determining a treaty benefit claim. In all likelihood, the ITD could basis the Circular deny treaty benefits.
- India's tax treaties with Singapore and Cyprus have already been modified by the MLI to include the PPT. The Circular's carveout for grandfathering provisions under those treaties is therefore unlikely to be material. 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.3
- The Circular provides once the ITD determines that obtaining a tax benefit was

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

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. The Circular does not emphasize on any standard of reasonable determination that the ITD must first make regarding the purpose of the transaction or arrangement before denying a treaty benefit. Instead, it places the entire burden on the taxpayer to show why that treaty benefit should apply. Moreover, the ITD's initial reasonable determination will be entirely discretionary, as the Circular requires all "***relevant facts and circumstances***" to be considered without providing any criteria or benchmarks.

- It is also 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 in tax treaties 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 an interpretation taking into account the object and purpose of the treaty as a whole, since it specifically states that treaty benefits are only to be granted for *bona fide* exchanges of goods and services, and movement of capital and persons.

- 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, several illustrative "***examples***" in both sources suggest substantial interpretative discretion in applying the PPT, particularly when ascertaining taxpayer intent.

- 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 standard for denying treaty benefits in such cases. It remains to be seen whether the Circular results in diluting this standard.

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 leaving decisions to a case-by-case interpretation. Given its binding nature,[4] its hoped that the ITD will not wield the Circular as a weapon with

4 *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).

which to deny treaty benefits to every taxpayer that in its opinion lacks sufficient "***substance***" or derives capital from third-country sources. At a broader level, the implementation of the PPT substantially dilutes the efficacy of Circular No. 789 of 2000[5], long used a shield against tax scrutiny.

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5 Circular 789 of 2000 provides that a TRC would constitute sufficient evidence for accepting the status of residence, as well as beneficial ownership for entitlement to the benefits of the India-Mauritius tax treaty. It has since been held to apply in the context of many of India's other tax treaties.