Tax Hotline

January 22, 2025

CBDT CLARIFIES APPLICABILITY OF PRINCIPAL PURPOSE TEST WHILE GRANTING TAX TREATY BENEFITS

- Provisions of PPT to apply prospectively
- Grandfathered transactions to be outside the purview of PPT
- Application of PPT to be carried out on a case-by-case basis, keeping in view the objective facts and findings

BACKGROUND

On October 1st, 2019, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, otherwise referred to as the Multilateral Instrument or MLI, came into force. Article 7 of the MLI is a minimum standard on treaty anti-abuse rules. It corresponds to the OECD's Base Erosion and Profit Shifting Action Plan 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstance, the final report on which recommended the introduction of one or more of the following three new treaty provisions, as a minimum standard to address treaty abuse:

a. The Principal Purpose Test ("**PPT**") only, which is a general anti-abuse rule based on the principal purpose of transactions or arrangements;

b. A PPT supplemented with either a simplified or a detailed LOB provision; or

c. A detailed LOB provision, supplemented by a mutually negotiated mechanism to deal with conduit arrangements not already dealt with in tax treaties.

Parties have an option to apply the simplified LOB ("**SLOB**") as a supplement to the PPT by making a notification to that effect. The SLOB provision applies to a covered tax agreement ("**CTA**") only when all the treaty partners have chosen to apply it. Where one treaty partner chooses to apply the SLOB and the other does not, then the SLOB does not apply and only the PPT applies symmetrically. While India has chosen to apply the PPT along with the SLOB, most Indian tax treaty partners have chosen to apply the PPT only. Hence as per compatibility rules, only PPT should apply in the context of such tax treaties.

In order for the PPT to apply (i) it should be reasonable to conclude that (ii) obtaining a benefit under the CTA is one of the principal purposes of the arrangement or transaction resulting in the benefit, and (iii) granting of the benefit is not in line with the object and purpose of the relevant provision of the CTA.

India had amended its tax treaties with Mauritius, Singapore and Cyprus to allocate India the right to tax capital gains arising on transfer of equity shares acquired after April 1, 2017. Acquisitions prior to April 1, 2017, were grandfathered from capital gains tax in India.

With introduction of PPT in such tax treaties pursuant to MLI or bilateral negotiation (in case of Mauritius), it was not clear whether the muster of PPT will have to be satisfied even in cases of grandfathered transactions. While technically, given the specific grandfathering it was possible to argue that PPT should not apply as it was the 'object and purpose' of the tax treaty to provide such benefit, there was no certainty on this aspect.

CLARIFICATION BY CBDT

The Indian tax department has issued a welcome clarification on application of the principal purpose test ("**PPT**") earlier today. We have summarized the clarifications below:

1. Period for which PPT applies: PPT should be applied prospectively.
   - Tax treaties (like Chile, China, Iran, Hongkong) in which PPT was negotiated bilaterally – PPT should apply from date of entry into force of the tax treaty or the amending protocol incorporating PPT
   - Tax treaties in which PPT has been incorporated through the multilateral instrument ("**MLI**") – the entry into effect of the PPT would depend on when the contracting state deposits the instrument for ratification. For tax treaty partners (like Australia, Ireland, Netherlands, Singapore, Luxembourg, UK, UAE etc.) who have deposited the instrument of ratification before June 30, 2019, PPT will be applicable from financial year ("**FY**") 2020-21.
2. Interaction of PPT with treaty-specific bilateral commitments: With respect to treaty specific bilateral commitments in form of grandfathering provisions under the India-Singapore tax treaty, India-Mauritius tax treaty and India-

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Cyprus tax treaty, it has been explicitly clarified that such provisions are not intended to interact with PPT. Therefore, the grandfathering provision are outside the purview of PPT.

3. The clarification also provides that PPT provision is expected to be a context-specific fact-based exercise, to be carried out on a case-by-case basis, keeping in view the objective facts and findings.

NDA COMMENTS

- Impact on India-Singapore tax treaty: India-Singapore tax treaty is a covered tax agreement ("**CTA**") for MLI purposes. PPT comes into effect from FY 2020-21 under the India-Singapore tax treaty. The table below summarizes different scenarios for PPT applicability under India-Singapore tax treaty.

S No	Transaction	Acquisition	Transfer	PPT applicability
1.	Transfer of equity share	Prior to April 1, 2017	Irrespective of date of transfer	Not applicable
		Post April 1, 2017	Prior April 1, 2020	Not applicable
		Post April 1, 2017	Post April 1, 2020	PPT applicable (however, in any case, there is no exemption on capital gain income upon sale of shares acquired post April 1, 2017)
2	Transfer of any other instrument	Prior to April 1, 2017	Prior April 1, 2020	PPT not applicable
		Prior to April 1, 2017	Post April 1, 2020	PPT applicable (therefore, for securities other than equity shares, PPT will apply even if acquisition is made prior to April 1, 2017)

Having said the above, the benefit of grandfathering under the India-Singapore tax treaty is subject to satisfaction of the limitation of benefit ("**LOB**") clause. The Singapore LOB also has a general clause which denies the capital gains tax benefit if the affairs are arranged with the 'primary purpose' of obtaining that benefit ("**Singapore LOB**"). The Singapore LOB is narrower than the PPT considering that Singapore LOB applies if the 'primary purpose' is to obtain benefit rather than 'one of the primary purpose'. Nevertheless, taxpayers will have to satisfy the muster of Singapore LOB. The other specific tests under the Singapore LOB in relation to shell / conduit companies not being entitled to benefits, minimum expenditure requirements etc. will continue to be applicable.

- Impact on India-Mauritius tax treaty: While Mauritius has not ratified the India-Mauritius tax treaty as a CTA, the tax department has nevertheless included Mauritius treaty in this clarification. This may be because of the 2024 protocol which proposed addition of PPT to the Mauritius tax treaty as well. The language of the 2024 protocol was rather confusing in so far as prospective or retrospective application of PPT was concerned. While the 2024 protocol has still not been notified, the current clarification makes it amply clear that PPT should not be applicable to grandfathered transactions. Having said this, once the 2024 protocol is notified, PPT should apply to provisions of India-Mauritius tax treaty. This will impact cases wherein exemption under tax treaty is being sought on transactions in securities other than equity shares considering capital gains on equity shares is nevertheless taxable in India. Importantly, India-Mauritius tax treaty does not have a limitation of benefit clause, therefore, PPT is likely to act as the only anti-abuse test.
- India-Cyprus tax treaty: India-Cyprus tax treaty is a covered tax agreement for MLI purposes. PPT should come into effect from FY 2021-22 under the India-Cyprus tax treaty. The implication The table below summarizes different scenarios for PPT applicability under India-Cyprus tax treaty.

S No	Transaction	Acquisition	Transfer	PPT applicability
1.	Transfer of equity share	Prior to April 1, 2017	Irrespective of date of transfer	Not applicable
		Post April 1, 2017	Prior April 1, 2021	Not applicable
		Post April 1, 2017	Post April 1, 2021	PPT applicable (however, in any case, there is no exemption on capital gain income upon sale of shares acquired post April 1, 2017)
2	Transfer of any other instrument	Prior to April 1, 2017	Prior April 1, 2021	PPT not applicable
		Prior to	Post April 1,	PPT applicable (therefore, for securities other than equity shares,

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	April 1, 2017	2021	PPT will apply even if acquisition is made prior to April 1, 2017)

India-Cyprus tax treaty does not have a specific LOB.

- Impact on other tax treaties: Certain other tax treaties like India-Netherlands tax treaty (PPT shall be effective from FY 2020-21) and India-Belgium tax treaty (PPT shall be effective from FY 2020-21) provide exemption from capital gains tax in certain situations. In contrast to the aforementioned tax treaties, taxpayers who seek to claim benefit under these treaties will have to satisfy the muster of PPT irrespective of the date of acquisition.
- Interplay with GAAR: at the outset, the GAAR provisions are narrower than PPT provisions as GAAR applies if (i) the 'main purpose' is to obtain tax benefit and (ii) the transaction satisfies other tests like arms' length test, commercial substance test, bona fide purpose test etc. Further, income-tax rules provide that GAAR provisions should not be applicable to income arising from transfer of investments made on or before April 1, 2017. Therefore, for transfer of equity share acquired prior to April 1, 2017, the transaction should be grandfathered both from PPT and GAAR.
- Impact on transactions in relation to other securities (like debentures): typically, capital gains arising from transfer of any security other than equity shares is taxable in the country of the alienator i.e. India does not have the right to tax such gains. Unlike equity transactions where PPT will not apply on acquisitions made prior to April 1, 2017, for transactions in any other security, PPT will have to be satisfied even if acquisition is made prior to April 1, 2017.

On an overall basis, the clarification is welcome and should go a long way in boosting investor confidence. Another aspect which may need to be considered is applicability of PPT in case of indirect transfers. In case where underlying shares are grandfathered or the shares at offshore level were acquired before April 1, 2017, then depending on language of treaty one will have to determine whether PPT will apply or not.

Neverthess, taxpayers will have to meet other tests necessary for obtaining relief under tax treaty.

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