



PRINCIPAL PURPOSE TEST (PPT) IN INDIA'S TAX TREATIES:

Background And Updates

A. BACKGROUND



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.**

B. MEANING OF PRINCIPAL PURPOSE TEST



The Principal Purpose Test (PPT) is a provision included in Tax Treaties between countries that have signed and ratified the 'Multilateral Instrument' (MLI), an action plan introduced by 'Organisation for Economic Co-operation and Development' (OECD) on **October 01st 2019** to address revenue leakage and tax avoidance in cross border arrangements.

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' (BEPS) Action Plan 6 – "Preventing the Granting of Treaty Benefits in inappropriate circumstance".**

Based on the above principles, one or more of the following three treaty provisions, as a minimum standard to address treaty abuse were introduced:

- The Principal Purpose Test ("PPT"), which is a general anti-abuse rule based on the principal purpose of transactions or arrangements;
- A PPT supplemented with either a simplified or a detailed 'Limitation of Benefit' (LOB) provision; or
- A detailed LOB provision, supplemented by a mutually negotiated mechanism to deal with conduit arrangements not already dealt with in tax treaties.

Treaty Partners 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

India has chosen to apply the PPT along with the SLOB, however 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.**



C. APPLICATION OF PPT



PPT seeks to deny the Tax Treaty benefits in cases:

- It should be reasonable to conclude that obtaining a benefit under the CTA is one of the principal purposes of the arrangement or transaction resulting in the benefit and
- Granting of the benefit is not in line with the object and purpose of the relevant provision of the tax treaty.

The PPT is intended to ensure that DTAAs apply in accordance with the objects and purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchange of goods and services, and movement of capital and persons.

D. CLARIFICATIONS BY CENTRAL BOARD OF DIRECT TAXES (CBDT)



CBDT issued Circular **No. 01/2025 on January 21, 2025** provides following guidance/clarifications on the application of the Principal Purpose Test (PPT) under India's Double Taxation Avoidance Agreements (DTAAs):

1. Prospective application: The PPT should be applied prospectively.

2. Period for which PPT applies:

- Tax treaties (like Chile, Iran, Hong Kong, China etc) 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 where the PPT has been incorporated through the MLI-from the date of entry into effect of the provisions of the MLI with respect to the DTAA specified in Article 35 of the MLI, as under:
 - a. with respect to taxes withheld at source on amounts paid or credited to non- residents, where the event giving rise to such taxes occurs on or after the first day of the previous year[#] that begins on or after the latest of the dates on which the MLI enters into force for the Contracting Jurisdictions to the DTAA
 - b. with respect to all other taxes levied by India for previous years[#] beginning on or after the expiration of a period of six calendar months from the latest of the dates on which the MLI enters into force^{*}

[#]For the above purposes, previous year shall be as defined in section 3 of the Income-tax Act, 1961.

^{*}For India, the date of entry into force of the MLI is 1st October 2019. The date of entry into force for the DTAA partner needs to be ascertained using OECD's MLI database.



3. Exclusions from PPT:

It is clarified that the grandfathering provisions under certain treaty-specific bilateral commitments in the form of grandfathering provisions under the **following DTAA's, as on date: (a) India-Cyprus DTAA; (b) India-Mauritius DTAA; and India-Singapore DTAA** shall remain outside the purview of the PPT provision and **remain governed by the specific provisions in this regard of the respective DTAA itself.**

4. 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 and Income Tax Department may consider additional resources like the BEPS Action Plan 6 Report and the UN Model Tax Convention Commentary as guidance while deciding on the invocation and application of the PPT provision, subject to India's reservations, wherever applicable.

5. Exclusions from PPT:

- 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.**
- 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.**
- As India-Mauritius Tax Treaty has not been ratified as CTA by Mauritius therefore, **PPT is likely to act as the only anti-abuse test** for the transactions post notification of the protocol issued on 7 March 2024 as the treaty does not have a specific LOB clause.
- As India-Cyprus tax treaty is a CTA for MLI purposes. PPT should come into effect from FY 2021-22 under the India-Cyprus tax treaty. As the treaty does not have a specific LOB clause, PPT is likely to act as the only anti-abuse test for the transactions post April 01, 2021
- As 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. Even though grandfathering provisions have been made applicable for the transactions prior to April 01, 2020, the benefit of grandfathering under the India-Singapore tax treaty is subject to satisfaction of the limitation of benefit ("LOB") clause which denies the capital gains tax benefit if the affairs are arranged with the 'primary purpose' of obtaining that benefit. Further, 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.





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