NEWSFLASH

CBDT issues clarification on applicability of PPT while granting Tax Treaty benefits

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Background

- The Principal Purpose Test ("PPT") is a key anti-abuse provision introduced as part of Action 6 under the OECD's Base Erosion and Profit Shifting ("BEPS") Project. This provision is outlined in Article 7 of the Multilateral Instrument ("MLI"), which addresses the prevention of treaty abuse.

- Its primary aim is to prevent the misuse of tax treaties by denying treaty benefits to arrangements/transactions where it is reasonable to conclude that obtaining such benefit was one of the principal purpose unless its is established that granting such benefit is in accordance with the object and purpose of the relevant provision of the Tax Treaty. When both countries involved in a tax treaty (referred to as Contracting Jurisdictions) adopt the MLI, the PPT alters the existing tax treaty to include its provisions.

- The PPT has become particularly significant for India, reflecting its dedication to combating BEPS and enhancing tax transparency. India has proactively worked to incorporate the PPT into its tax treaties, both through the MLI framework and direct negotiations with treaty partners. Countries like Mauritius, Singapore once favored for investment due to their advantageous tax structures, have seen updates to their treaties with India to include the PPT. A notable milestone was the revision of the India-Mauritius tax treaty in March 2024, explicitly embedding the PPT which marked a significant change, as Mauritius had long been considered a conduit for foreign investment into India under the earlier favorable tax treaty terms.

- CBDT has now issued a Circular[1] providing guidance on the applicability of PPT under India's tax treaties ensuring clarity on its interpretation and consistent approach in its enforcement.

[1] Circular No. 01/2025 dated 21st January 2025 [F.No. 500/05/2020/FT&TR-II]

CBDT Circular

CBDT has issued clarification **on applicability of PPT under India's tax treaty, to be applied prospectively**. Key points include:

1. **Grandfathering Provisions:**
   - The grandfathering provisions under the India-Cyprus, India-Mauritius, and India-Singapore tax treaties shall be outside the purview of the PPT.
   - Transactions or investments made before the introduction of the PPT will not be reassessed under this provision.
   - These provisions will continue to be governed by the specific terms outlined in the respective tax treaties.
2. **Applicability of PPT provision:**
   - For **bilateral agreements wherein PPT has been incorporated** (e.g., with Chile, Iran, Hong Kong, China): The PPT applies from the date the tax treaty or the amending protocol incorporating the PPT enters into force.
   - For **tax treaties wherein PPT has been incorporated through the MLI**:
     - *Taxes withheld at source:* The PPT applies on or after the first day of the previous year beginning after the latest of the dates on which the MLI enters into force for Contracting jurisdictions to the tax treaty.
     - *Other taxes:* The PPT applies to previous years starting six months after the latest of the dates on which the MLI enters into force for Contracting jurisdictions to the tax treaty.
3. **Dates to Note:**
   - For India, the MLI entered into force on **1st October 2019**. The date of entry into force for the tax treaty partner to be verified using the **OECD's MLI database**.
   - The term "previous year" is as defined under Section 3 of the Income-tax Act, 1961.
4. Application of the PPT provision to be a context-specific fact-based exercise to be carried on a case-by-case basis keeping in view the objective facts and findings.

Our Comments

The clarification is a welcome step by the CBDT and has provided much-needed clarity regarding the application of the PPT provisions under India's tax treaties. It also ensures certainty that past investments made under existing treaties will not be subjected to retrospective treatment under the PPT framework. Further, these provisions have protected the bilateral commitments thereby giving preeminence to the grandfathering provisions under the tax treaties with Cyprus, Mauritius, and Singapore to be out of the purview of PPT framework. By safeguarding historical transactions from additional scrutiny, the move is expected to boost investor confidence, promote certainty in tax planning and positively influence future cross-border investments into India.

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