

Direct Tax Alert

January 30, 2025

The Principal Purpose Test and its Impact on Indian Tax Treaties

The CBDT has issued a clarification vide Circular No. 01/2025¹, dated January 21, 2025, regarding the application of the Principal Purpose Test under Indian tax treaties.

A. Introduction

India has amended its tax treaties with Mauritius, Singapore, and Cyprus allocating the taxing rights for capital gains arising from the alienation of shares which are acquired after April 1, 2017. Capital Gains arising from the alienation of shares acquired before April 1, 2017 are grandfathered, in other words, they continue to remain exempt from capital gains tax in India even after amendment to tax treaties.

Alongside these treaty amendments, India has also embraced the global shift towards stronger anti-abuse measures in international taxation. On October 1, 2019, BEPS Multilateral Instrument (MLI) came into force,

marking a pivotal moment in international tax reform. The MLI is designed to combat tax avoidance strategies, and one of its most crucial provisions is Article 7, which introduces a minimum standard for treaty anti-abuse rules. This aligns with the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan 6, which aims to ensure that tax treaties are not misused to avoid taxes inappropriately.

A key provision of this action plan is the Principal Purpose Test ('PPT'), designed to prevent tax avoidance in situations where the one of the principal purposes of a transaction or arrangement is to obtain treaty benefits that are not in line with the intent of the tax

¹ <https://incometaxindia.gov.in/communications/circular/circular-1-2025.pdf>



treaty. The PPT operates by denying treaty benefits in respect of an item of income:

- when it is reasonable to conclude that obtaining a benefit whether directly or indirectly under a tax treaty is one of the principal purposes of a transaction or arrangement; and
- the taxpayer fails to establish that granting such a benefit would be consistent with the object and purpose of the relevant provision of the treaty.

With the introduction of the PPT into these treaties, questions arose regarding its application to the grandfathered transactions. While some argued that these grandfathered transactions should be exempt from the PPT's scrutiny, as the object and purpose of the treaty was to provide such benefits, uncertainty persisted regarding its retrospective application for the grandfathered transactions.

B. CBDT Clarification

In response to this uncertainty, the Indian tax authorities, through the Central Board of Direct Taxes (CBDT), have issued a much-needed clarification vide **Circular No. 01/2025 dated 21st January, 2025** regarding the application of the PPT. The key takeaways from this clarification are as follows:

1. Prospective Application of PPT:

- For treaties like those with Chile, China, Iran, and Hong Kong, where the PPT was negotiated bilaterally, the PPT applies from the date of entry into force of the respective tax treaty or amending protocol.
- For treaties covered under the MLI, the entry into effect of the PPT depends on when the contracting state deposits the instrument.
 - 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 (as per the Section 3 of the Income-tax Act, 1961) 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.

- The date of entry into force of the MLI for India is October 1, 2019. The date of entry into force for the DTAA partner needs to be ascertained using OECD's MLI database.

2. Impact on Grandfathered Transactions:

- The clarification explicitly stated that the grandfathering provisions under India's tax treaties with Mauritius, Singapore, and Cyprus will not be subject to the PPT. This means that transactions involving shares acquired before April 1, 2017, under these treaties, will not face scrutiny under the PPT.

3. Fact-Based Case-by-Case Approach:

- The PPT will be applied on a case-by-case basis, taking into account the specific facts and circumstances surrounding each transaction. The CBDT has emphasized that this test is contextual and fact-based, ensuring that a thorough review is conducted for each situation to determine whether the principal purpose of the transaction was tax avoidance.

4. Impact of CBDT Clarification:

a) India-Singapore Tax Treaty:



- The India-Singapore tax treaty is a covered tax agreement under the MLI, with the PPT coming into effect from FY 2020-21. For gains arising on shares acquired before April 1, 2017, PPT is not applicable regardless of the transfer date. However, for shares acquired on or after April 1, 2017, and transferred post-April 1, 2020, PPT applies, though there is no capital gains tax exemption for shares acquired after April 1, 2017. For gains arising on instruments other than shares, PPT applies where the transfer of these instruments are made on or after April 1, 2020, irrespective of the acquisition date.
- While PPT introduces an additional layer of scrutiny, the benefit of grandfathering under the treaty is subject to compliance with the Limitation of Benefits (LOB) clause. The Singapore LOB clause includes specific provisions targeting arrangements structured with the '*primary purpose*' of obtaining treaty benefits, which is narrower in scope than PPT's '*one of the primary purposes*' test.
- Additionally, the Singapore LOB imposes specific conditions related to shell or conduit companies, including minimum expenditure requirements and substance tests. Taxpayers must ensure that these conditions are met to continue claiming treaty benefits.

b) India-Cyprus Tax Treaty:

- The PPT will come into effect from FY 2021-22 under the India-Cyprus tax treaty. The Cyprus treaty does not have a specific LOB clause, making the PPT a primary tool for evaluating potential treaty abuse.
- In this case as well, for gains arising on shares acquired before

April 1, 2017, PPT is not applicable regardless of the transfer date. However, for shares acquired after April 1, 2017, and transferred post-April 1, 2021, PPT applies, though there is no capital gains tax exemption for shares acquired after April 1, 2017. For gains arising on instruments other than shares, PPT applies where transfer of these instruments are made on or after April 1, 2021, irrespective of the acquisition date.

c) India-Mauritius Tax Treaty:

- In the case of the India-Mauritius tax treaty, while Mauritius has not yet ratified the amendment through the MLI, the CBDT clarification makes it clear that the PPT will not apply to grandfathered transactions.
- However, once the 2024 protocol between India and Mauritius is ratified, the PPT will apply, potentially affecting gains arising on transactions involving instruments other than shares. The LOB clause contained in Article 27A of the India-Mauritius treaty deals with only beneficial tax rates for transactions during specified period. Thus, the PPT will serve as the anti-abuse mechanism.

d) Other Tax Treaties:

- In addition to the treaties with Mauritius, Singapore, and Cyprus, the PPT will also impact other treaties, such as those with the Netherlands and Belgium. These treaties offer exemptions from capital gains tax, but the PPT will apply irrespective of the date of acquisition, and taxpayers will need to satisfy the PPT criteria to claim tax benefits.

e) GAAR and PPT:

- GAAR applies when the 'main purpose' of an arrangement is to



obtain a tax benefit, and the arrangement must also satisfy one of the additional tests, such as the arms' length test, commercial substance test, or bona fide purpose test, among others. Importantly, the Income-tax rules in India stipulate that GAAR will not apply to income arising from the transfer of investments made before April 1, 2017. Transactions involving transfer of shares acquired prior to this date are grandfathered from GAAR provisions. Given this, it is important for taxpayers to recognize that, for such share transfers, both the PPT and GAAR will not apply. However, for shares acquired post-April 1, 2017, the provisions of PPT may apply based on the above discussion and provisions of GAAR may also apply.

f) Instruments other than shares:

- Generally, the capital gains arising from the transfer of instruments other than shares are taxable in the country of the alienator. Under the tax treaties India does not generally have the right to tax such gains. However, unlike the treatment of shares, where the PPT does not apply to acquisitions made before April 1, 2017 (due to the grandfathering provisions), transactions involving other instruments will still be subject to the PPT, regardless of the acquisition date.

Dhruva Comments

The recent clarification issued by the CBDT provides much-needed clarity on the application of PPT under Indian tax treaties. By confirming that the PPT will apply prospectively and clarifying its interaction with grandfathering provisions, the CBDT has

reduced uncertainty and mitigated concerns about retrospective scrutiny. This is a positive development for cross-border investors, particularly those relying on tax treaties with Mauritius, Singapore, and Cyprus.

While the clarification provides much-needed relief, taxpayers should remain vigilant and ensure that their transactions do not attract the relevant anti-abuse provisions, such as the PPT and any applicable LOB clauses. The CBDT's emphasis on a fact-based, case-by-case approach means that each transaction will be evaluated in context, reinforcing the need for clear commercial substance in cross-border arrangements.

The PPT provision will apply to all types of income under respective tax treaties. However, the CBDT clarification with respect to grandfathering provisions under Mauritius, Singapore, and Cyprus tax treaties, applies to capital gains and not to other types of income such as dividends, interest, royalties, fees for technical services, etc.

Overall, the clarification strengthens investor confidence and aligns India's tax treaty framework with global anti-abuse standards, while honoring the intent of providing tax benefits to genuine cross-border transactions.

Contributors

[Ashish Jain \(Principal\)](#)

[Komal Mehta \(Manager\)](#)

[Tapan Jhanwar \(Senior Associate\)](#)

For any queries in relation to this tax alert, please feel free to reach out.



ADDRESSES

Mumbai

1101, One World Centre,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad

402, 4th Floor, Venus Atlantis,
100 Feet Road, Prahladnagar,
Ahmedabad 380 015
Tel: +91 79 6134 3434

Bengaluru

Lavelle Road, 67/1B,
4th Cross, Bengaluru,
Karnataka – 560001
Tel: +91 90510 48715

Delhi / NCR

305-307, Emaar Capital Tower - 1,
MG Road, Sector 26, Gurgaon
Tel: +91 124 668 7000

New Delhi

A-1/19 Ground floor, B4 block,
Nauroji Nagar, Safdarjung Enclave,
New Delhi – 110029
Tel: +91 11 4514 3438

Gift City

Pragya Accelerator, Unit FF 36,
Block 15, GIFT SEZ,
Gandhi Nagar- 382050,
Gujarat.
Tel: +91 7878577277

Pune

305, Pride Gateway,
Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Kolkata

4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal – 700016
Tel: +91-33-66371000

Abu Dhabi

Dhruva Consultants
1905 Addax Tower, City of Lights,
Al Reem Island,
Abu Dhabi, UAE
Tel: +971 26780054

Dubai

Dhruva Consultants
207, Emaar Square,
Building 4 PO Box 127165,
Dubai, UAE
Tel: +971 4 240 8477

Singapore

NeoDhruva Consultants
#16-04, 20 Collyer Quay,
Singapore 049319
Tel: +65 9144 6415

KEY CONTACTS

Dinesh Kanabar

Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Punit Shah (Mumbai)

punit.shah@dhruvaadvisors.com

Mehul Bheda (Ahmedabad/ GIFT City)

mehul.bheda@dhruvaadvisors.com

Aditya Hans (Bengaluru/ Kolkata)

aditya.hans@dhruvaadvisors.com

Vaibhav Gupta (Delhi/ NCR)

vaibhav.gupta@dhruvaadvisors.com

K. Venkatachalam (Pune)

k.venkatachalam@dhruvaadvisors.com

Nimish Goel (Middle East)

nimish.goel@dhruvaadvisors.com

Dilpreet Singh Obhan (Singapore)

dilpreet.singh@dhruvaadvisors.com

Dhruva Advisors has been consistently recognised as the **“India Tax Firm of the Year”** at the ITR Asia Tax Awards in 2017, 2018, 2019, 2020 and 2021.

Dhruva Advisors has also been recognised as the **“India Disputes and Litigation Firm of the Year”** at the ITR Asia Tax Awards 2018 and 2020.

WTS Dhruva Consultants has been recognised as the **“Best Newcomer Firm of the Year”** at the ITR European Tax Awards 2020.

Dhruva Advisors has been recognised as the **“Best Newcomer Firm of the Year”** at the ITR Asia Tax Awards 2016.

Dhruva Advisors has been consistently recognised as a **Tier 1 Firm in India for General Corporate Tax** by the International Tax Review’s in its World Tax Guide.

Dhruva Advisors has also been consistently recognised as a **Tier 1 Firm in India for its Transfer Pricing** practice ranking table in ITR’s World Transfer Pricing guide.

Dhruva Advisors has been consistently recognised as a **Tier 1 Firm in India for Indirect Taxes** in International Tax Review’s Indirect Tax Guide.

Disclaimer:

This information contained herein is in summary form and is therefore intended for general guidance only. This publication is not intended to address the circumstances of any particular individual or entity. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation. This publication is not a substitute for detailed research and opinion. Before acting on any matters contained herein, reference should be made to subject matter experts and professional judgment needs to be exercised. Dhruva Advisors LLP cannot accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication