



Tax Flash News



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Grandfathering provision under the tax treaty is outside the purview of the Principal Purpose Test: CBDT circular

Executive summary



Recently, several Indian tax treaties were amended to include the Principal Purpose Test (PPT) aimed at preventing treaty abuse.

Some of the Indian treaties have grandfathering provisions. For instance, capital gains article of the India-Singapore tax treaty provides that gains arising to a Singaporean tax resident from the alienation of shares acquired before 1 April 2017 in a company resident in India shall not be taxable in India.

There has been some confusion regarding the application of the PPT provision when income is not taxable in India due to the grandfathering provisions in the relevant tax treaty.

To address this, the CBDT has issued a circular¹ clarifying that the grandfathering provisions in the treaties are excluded from the scope of the PPT provision.

¹ CBDT Circular no. 1 dated 21 January 2025



PPT to be applied prospectively

The provision relating to PPT provides that the treaty benefits will not be granted if it is reasonable to conclude, based on relevant facts and circumstances, that one of the primary purposes of a transaction or arrangement was to obtain those benefits. However, the benefits may still be allowed if it is established that granting them aligns with the relevant treaty provisions' objectives and purpose.

The circular clarifies that the PPT would be applied prospectively as discussed in below table:

Treaties	Date of entry into force/effect
Treaties where the PPT has been incorporated through bilateral process (such as Chile, Iran, Hong Kong, China, etc.)	In accordance with the respective treaty or the amending protocol incorporating the PPT, as the case may be.
Treaties where the PPT has been incorporated through the Multilateral Instrument (MLI)	<p>In accordance with the provisions of MLI summarised as under:</p> <p>For India, the date of entry into force of the MLI is 1 October 2019.</p> <p>Entry into effect, with respect to taxes (other than withholding taxes²) is first day of taxable period beginning on or after the expiry of six calendar months following the latest of the dates on which MLI enters into force for each of the treaty country.³</p>

The aforesaid date for the application of PPT shall be subject to the treaty specific bilateral commitments as set out on the next page.

² For Withholding Taxes (WHT): Date of entry into effect is on or after the first day of the taxable period following the latest of the dates on which MLI enters into force for each of the treaty country.

³ For instance, for Indian treaties with the Netherlands, the UK, Singapore, date of entry into effect is 1 April 2020.

Treaty-specific bilateral commitments

India has made certain treaty-specific bilateral commitments in the form of grandfathering provisions under the following treaties:

- (a) India-Cyprus tax treaty,
- (b) India-Mauritius tax treaty, and
- (c) India-Singapore tax treaty.

These commitments, as reflected in the bilaterally agreed object and purpose of such grandfathering provisions, are not intended to interact with the PPT provision as such.

Accordingly, the grandfathering provisions under such treaties would be governed by the specific treaty provision and would remain outside the purview of the PPT provision.

Additional/supplementary sources of guidance

The application of the 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.

In this regard, the tax authorities may refer to the BEPS Action Plan 6 Final Report and UN Model Tax Commentary 2021 as additional/supplementary sources of guidance while deciding on the invocation and application of the PPT provision.

However, such a reference shall be subjected to India's reservations, wherever applicable.

Our comments



This is a positive development with respect to investments made prior to 1 April 2017. The application of the PPT would not affect the eligibility of tax exemption in India as per the grandfathering provisions under a treaty.

The circular appears to acknowledge that granting treaty benefit under the grandfathering provision aligns with the object and purpose of that provision. Thus, such benefit should not be denied due to the application of the PPT.

Further, the circular clarifies that the PPT provision will be applied prospectively. For instance, in the case of the India-Singapore treaty, the PPT provision comes into effect from 1 April 2020. Thus, the transaction occurring prior to that date will not be subjected to the PPT provision.

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