
THE IMPACT OF THE MULTILATERAL INSTRUMENT AND THE PRINCIPAL PURPOSE TEST ON INTERNATIONAL TAXATION: ADDRESSING BASE EROSION AND PROFIT SHIFTING

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ABSTRACT

Examining the *Principal Purpose Test* (PPT), first presented as a major clause under the *Multilateral Instrument* (MLI) in the framework of the *OECD's Base Erosion and Profit Shifting* (BEPS) *Action 6*, reveals important consequences for multinational corporations and their strategy to avoid tax in treaty jurisdictions. The PPT has generated a lot of debate even if its stated use is to curb aggressive tax planning and reduce treaty misuse. This project explores how well the PPT addresses these problems, paying especially close attention to how it affects legal certainty about foreign taxation. It also looks at the wider ambit of the OECD's BEPS Project and the MLI, with a particular emphasis towards the intricate interaction between the PPT and *Limitation-on-Benefits* (LOB) clauses as well as its compliance with national tax laws. The results show that the PPT's function as a *general anti-avoidance rule* (GAAR) under the MLI has several difficulties that might limit its whole efficacy in combating tax evasion techniques.

Keywords: BEPS, Tax treaties, Principal Purpose Test (PPT), Multilateral Instrument (MLI).

Introduction

Rising in response to the financial crisis of 2008, the Base Erosion and Profit Shifting (BEPS) Project underlines the urgent need of reforms in international taxation to guarantee corporate earnings are taxed where genuine economic activity happens and value is produced. Together, the Organisation for Economic Co-operation and Development (OECD) and G20 nations developed a 15-point BEPS Action Plan meant to counteract tax avoidance strategies by means of mismatches in national tax rules, therefore distributing earnings from high-tax to low-tax nations. Steps to eliminate double non-taxation, reduce treaty abuse, and enhance world tax governance were described when the last BEPS Action Reports were released in 2015.

A major turning point in this endeavour came while signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) in Paris on June 7, 2017. Signed by 68 industrialised and developing countries—including India, the United Kingdom, Canada, Germany, Italy, and Russia—the MLI provides a more unified and effective method to manage BEPS issues by permitting simultaneous revisions to a big network of bilateral tax treaties. This structure could affect more than 1,101 treaties, therefore altering cross-border tax systems. But major absences like the United States and Brazil as well as selective implementation by some members hamper world tax coordination.¹ Germany signed the MLI, for instance, but has not followed its provisions regarding its tax treaty with India, therefore raising issues about cross-border investment.²

Using the MLI brings about notable changes in world tax planning. Adoption of minimal standards is a basic feature of the Principal Purpose Test (PPT), which excludes treaty benefits if one of the main objectives of a transaction is to acquire such advantages. This clause's subjective nature causes interpretational challenges for businesses and tax authorities, but its intention is to lower tax avoidance. Moreover casting extra uncertainty on whether both clauses could be applied concurrently to the same transaction is India's recently implemented General Anti-avoidance Rules (GAAR).

¹*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, (Feb. 20, 2023), https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/beps-mli/multilateral-instrument-beps-tax-treaty-information-brochure.pdf/_jcr_content/renditions/original./multilateral-instrument-beps-tax-treaty-information-brochure.pdf.

² *Base erosion and profit shifting (BEPS)*, (May 30, 2024), <https://www.oecd.org/en/topics/policy-issues/base-erosion-and-profit-shifting-beps.html>.

From the perspective of a taxpayer, the MLI imposes major limitations even if it helps to reduce tax avoidance. While these decisions directly impact taxpayers, their minimal participation in the Mutual Agreement Procedure (MAP) between states begs serious concerns. Moreover, even if the MLI enhances anti-avoidance rules and openness, it also brings administrative and compliance complexity that can affect company simplicity of operation.³

BEPS has a significant financial impact since income losses projected between USD 100 to 240 billion yearly—equivalent of around 4–10% of world corporate income tax revenue. Beyond simply financial concerns, BEPS rules damage the integrity of national tax systems and create an unfair competitive environment whereby international corporations profit unfairly over home enterprises.⁴ By establishing a consistent and efficient framework to implement BEPS-related reforms, the MLI marks a historic turning point in international taxes and thereby shapes the course of world tax policies.

Together with domestic tax laws and bilateral tax treaties, the MLI marks a major change in the global tax scene by adding a third layer of tax control. Two among its several clauses stand out as especially important: the Principal Purpose Test (PPT) in Article 7(1) and the introductory language in Article 6(1). Under BEPS Action 6, these clauses—which have been agreed generally by all signatories—form the pillar of the OECD's minimum requirement for avoiding tax treaty abuse.

Historically, bilateral tax treaties have had gaps that let tax avoidance flourish, often leading to double non-taxation instead of just reducing double taxation. Among the major issues are treaty shopping, dividend transfer transactions, and unclear definition of permanent enterprises. Reiterating such problems, the BEPS Action 6 Report, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, urges the inclusion of anti-abuse rules in tax treaties. The MLI offers the principal tool for rapidly adopting these changes by allowing states to revise their present tax treaties without resorting to protracted renegotiations.

Though the PPT under Article 7 of the MLI is supposed to aid to lower tax treaty abuse, its adoption has generated much debate and uncertainty. First analysing the legal structure that resulted in the inclusion of Article 7 in the MLI, this project seeks to investigate these issues.

³ *India's MLI Positions: Impact on Availing Treaty Benefits*, NISHITH DESAI ASSOCIATES (July 4, 2017), https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/India_s_MLI_Positions.pdf.

⁴ *Supra* Note 2.

It will then look at the PPT's scope and use to ascertain whether it either helps to create legal uncertainty or rather lessens treaty abuse and tax evasion. The reasonableness test included in the PPT, the judicial interpretation of the provision in the Indian legal environment, and their relationship with India's General Anti-Avoidance Rule (GAAR) will be especially underlined. By means of critical analysis of these features, this paper aims to examine the general influence of the PPT on international tax law and its consequences for multinational corporations.

Chapter I. The Principal Purpose Test as a Key Pillar of International Tax Agreements

The Evolution of Base Erosion and Profit Shifting (BEPS)

Along with its Explanatory Statement in November 2016, the OECD proposed the Multilateral Convention, sometimes known as the Multilateral Instrument (MLI), in an attempt to quickly implement policies to fight tax treaty-related Base Erosion and Profit Shifting (BEPS). Key revisions to tax treaties as recommended under the BEPS Action Plans—specifically, Action 2 (hybrid mismatches),⁵ Action 6 (treaty abuse),⁶ Action 7 (artificial avoidance of permanent establishment status), and Action 14 (improving dispute resolution processes) are incorporated by the MLI.⁷ The Explanatory Statement that goes with it clarifies the Convention's provisions.

Action 6 of the BEPS framework set a minimum criterion that nations might include into their tax treaty networks to handle treaty abuse. Following the financial crisis of 2008, BEPS attracted worldwide attention and spurred the OECD to create a 2013 paper called "Addressing Base Erosion and Profit Shifting." Responding to this report, OECD members and G20 countries developed a thorough 15-point Action Plan to reduce BEPS, sometimes known as the BEPS Action Plan. Participating nations, including India, worked together over the next two years to hone and apply this strategy, producing the BEPS Action Reports in 2015.⁸

These studies have as their main objectives eradicating cases of double non-taxation, preventing treaty misuse, and guaranteeing that profits be taxed in the country where economic value is generated. To reach this, the papers call for major structural changes in the current international tax treaty structure.

The Multilateral Instrument's (MLI) Part in Play

The BEPS Action Reports' thoroughness notwithstanding their implementation presented major difficulties. Individual, bilateral treaty modification would have been a protracted and

⁵ 2015 OECD, Final Report on Hybrid Mismatches.

⁶ 2015 OECD, Final Report on Treaty Abuse.

⁷ *Id.*

⁸ *Supra* Note 1.

difficult procedure with possible contradictions deriving from different political goals and negotiating dynamics across borders.⁹

Understanding this problem, the BEPS Action Plan suggested the use of a Multilateral Instrument as a quick and coordinated tool for carrying out tax treaty-related changes. This strategy guaranteed that the requisite adjustments could be implemented right away and preserved the flexibility needed for general worldwide consensus in addressing BEPS.

Commonly known as the Multilateral Instrument (MLI), more than seventy nations signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on June 7, 2017. This agreement was intended to concurrently change many bilateral tax treaties, therefore simplifying the process of addressing BEPS issues.¹⁰

The MLI is set up to give participating nations a degree of flexibility by letting them choose from a set of few choices. But it also requires following specific minimal criteria, one of which is Action 6—focused on stopping treaty benefits from being granted under unsuitable conditions. The MLI's aim of reducing treaty abuse and guaranteeing the integrity of international tax accords depends critically on this clause.¹¹

The Principal Purpose Test and Treaty Shopping

By means of Action 6 of the BEPS Project, the OECD has found tax treaty abuse—especially treaty shopping—as a major issue aggravating base erosion and profit shifting. Members of the Inclusive Framework on BEPS agreed to include protections into their bilateral tax treaties in order to counteract this problem and stop such exploitation.

Under this program, the Action 6 Report presents three feasible strategies for combating treaty abuse. Countries have to at least apply one of the following anti-abuse policies inside their treaties:

1. As a *stand-alone provision*, a Principal Purpose Test (PPT) serves as a broad anti-abuse

⁹ Supra Note 3.

¹⁰ Organization For Economic Co-Operation And Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting (June 2017).

¹¹ Sam Sholli, *MLI: Testing the 'principal purpose'*, International Tax Review (Dec. 12, 2018), <https://www.internationaltaxreview.com/article/2a68waxrsfwayuqfhlvk/mli-testing-the-principal-purpose>.

guideline depending on the main objective behind transactions or agreements.

2. A **PPT together with a simplified or elaborate Limitation on advantages** (LOB) clause adds more criteria to limit treaty advantages.
3. A **thorough LOB clause matched by a mutually agreed procedure** to handle conduit arrangements not specifically covered under current tax treaties.¹²

Although the pre-existing tax treaties lack an identical article, if a nation chooses the PPT as its main treaty abuse prevention mechanism under the MLI framework, this clause will automatically apply to all of its Covered Tax Agreements (CTAs).¹³ Any tax treaty a signatory to the MLI has selected to alter in line with MLI terms is known as CTA.

The PPT is codified in **Paragraph 1 of Article 7 of the MLI**,¹⁴ which states:

“Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.”

An Explanatory Statement (ES) was produced alongside the MLI paper to help to clarify the intended use of the MLI. This comment captures the agreement among MLI negotiators about how their terms should change current tax treaties. Though in terms of interpretation the ES does not have binding power for MLI signatories, which would cause questions about its applicability.¹⁵

¹² Organisation for Economic Co-operation & Development, *Preventing Tax Treaty Abuse*, <https://www.oecd.org/en/topics/sub-issues/preventing-tax-treaty-abuse.html> (last visited 08 February 2025).

¹³ Nishith Desai Associates, *India's MLI Positions*, http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/India_s_MLI_Positions.pdf (last visited 07 February 2025).

¹⁴ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, art. 7, *opened for signature* June 7, 2017 (entered into force July 1, 2018).

¹⁵ Blazej Kuzniacki, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI : Exploring Challenges Arising from its Legal Implementation and Practical Application*, World Tax Journal – Amsterdam, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4224397.

Lack of a well-defined implementation method is one of the main difficulties in applying the PPT. Though the 2017 OECD Model Tax Convention (MTC) offers striking instances in its Commentary on Article 29(9), these examples fall short in offering a disciplined methodology for regularly using the PPT.¹⁶ This uncertainty calls for a consistent interpretation to guarantee that international trade and investment are not negatively impacted even if tax treaty abuse is limited. Scholars and professionals have examined many aspects of the PPT to better grasp its relevance in the lack of comprehensive OECD direction.

Dealing with treaty shopping: a three-pronged strategy

Using a three-fold approach including the following components, the Final Report on BEPS Action 6 aims to discourage treaty shopping:

1. Tax treaties clearly specify that contracting governments want to expressly eradicate chances for treaty shopping and intend to prevent tax avoidance when signing a treaty.
2. Within the OECD Model Convention, the inclusion of a particular Limitation-on-Benefits (LOB) clause inspired on LOB clauses present in U.S. tax treaties.
3. A general anti-abuse rule, like the PPT, which assesses whether a main goal of a transaction or arrangement was to acquire treaty benefits in a way incompatible with the purposes of the treaty.

Under this approach, should the transaction or arrangement match the larger goal and objective of the tax treaty, the PPT will not apply and treaty benefits will remain accessible. The preamble of the treaty clearly says that its intention is to prevent treaty shopping, therefore suggesting this alignment. A main tool for combating tax avoidance is the PPT included in Article 29 of the 2017 OECD Model Convention.

Particularly in light of the financial crisis, the problem of treaty shopping has attracted growing worldwide attention. Many governments see it as troublesome when businesses create intermediary organisations in nations with more favourable tax treaties—often resulting in

¹⁶ Vita Apriliasari, *Interpretation Issue of the Principal Purpose Test*, Journal Pajak Indonesia, https://www.researchgate.net/publication/357025771_INTERPRETATION_ISSUE_OF_THE_PRINCIPAL_PURPOSE_TEST.

either lowered or abolished withholding tax liabilities. As a result, numerous countries have given efforts to solve treaty shopping top priority since they view it as a threat to fair taxes.

Designed to complement the ideas expressed in the Commentary on Article 1 of the OECD Model Convention, the third prong of the OECD's approach—the PPT as a general anti-abuse provision—is meant to This clause guarantees that, against the fundamental goals of the pertinent treaty provisions, treaty benefits are limited when one of the main reasons of an arrangement is to provide an unfair tax advantage.¹⁷

The MLI has important components to handle treaty shopping in line with BEPS Action 6 recommendations, including:

- Preamble paragraph bolstering the intention to reduce tax avoidance and reflecting the 2017 OECD Model Convention.
- Like Articles 29(1)-(7) of the 2017 OECD Model Convention, which adds further criteria for entities to qualify for treaty benefits, a Simplified Limitation-on- Benefits (SLOB) clause imposes extra obligations for entities.
- Comparable to the PPT in Article 29(9) of the OECD Model Convention, a general anti-abuse rule guarantees that treaty advantages are not awarded in circumstances where gaining such benefits was a main goal of the arrangement.¹⁸

This clause is very important in resolving tax treaty shopping issues worldwide since governments that have signed the MLI are obliged to adopt the modified preamble language in Article 6(1) to fulfil the minimal bar for BEPS Action 6 compliance.¹⁹

¹⁷ Organisation for Economic Co-operation & Development, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report* (Oct. 5, 2015), https://www.oecd.org/en/publications/2015/10/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-action-15-2015-final-report_g1g58cf4.html.

¹⁸ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, art. 7(1), *opened for signature* June 7, 2017 (entered into force July 1, 2018).

¹⁹ David G. Duff, *Tax Treaty Abuse and the Principal Purpose Test: Part II*, The Peter A. Allard School of Law Faculty Publications,

Chapter II. Addressing Uncertainties Surrounding the Principal Purpose Test

The OECD has found that one main way businesses participate in BEPS activities is treaty abuse—more especially, treaty shopping. In response, the BEPS Project's Action 6 included the inclusion of the Principal Purpose Test (PPT) in tax treaties as one of several initiatives meant to combat such behaviours.²⁰

The PPT has been hotly debated from its inception, with arguments both for and against its use. Formally, the *clause is found in Article 7 of the Multilateral Instrument* (MLI), which aims to operationalise treaty changes connected to BEPS.²¹

India signed the MLI in June 2017 and approved it by government in 2019, therefore rendering its terms legally obligatory and relevant to India's tax treaties undercovering MLI framework. Consequently, Article 7 of the MLI calls for examination in the Indian setting especially in view of constitutional values and accepted tax law.²² Although there is no clear solution about its legitimacy, several academics have put out diverse points of view on this matter. The constitutional aspects of Article 7 will be examined in this part together with the main legal issues it poses.

Article 7 of the MLI²³ states that, unless obtaining such a benefit aligns with the objective and purpose of the relevant treaty provisions, treaty benefits will not be granted for any income or capital item should it be reasonable to conclude—based on all relevant facts and circumstances—that obtaining such a benefit was one of the main purposes of the arrangement or transaction.

One of the main issues about this clause is its vague and wide phrasing. The Indian Constitution maintains the idea that no tax can be imposed without the authority of law, hence such laws must not violate basic constitutional values. Adherence to the rule of law is one of these ideas

²⁰ *Supra* Note at 13.

²¹ Celena Bergdahl, *Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument*, International Bureau of Fiscal Documentation, <https://www.ibfd.org/shop/journal/anti-abuse-measures-tax-treaties-following-oecd-multilateral-instrument-part-1>.

²² Government of India, *Ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, Press Information Bureau, (2019) Retrieved from <https://pib.gov.in/Pressreleaseshare.aspx?PRID=1574096>.

²³ Organisation for Economic Co-operation & Development, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, art 7, *opened for signature* January 1, 2017.

since laws must be reliable and predictable in their application. The PPT's ambiguous language begs questions regarding possible implementation uncertainty, which calls for more research of its main elements.

Important components for using the PPT

Three important factors have to be investigated to ascertain whether the PPT fits a certain situation:

- 1 ***“The main goals of any agreement or transaction”*** Evaluating whether a major driving force was tax advantages.
- 2 ***“Reasonable to conclude, with regard to all pertinent facts and circumstances”*** Setting a level for deciding intention.
- 3 ***The exception rule enabling treaty advantages*** if they complement the goal and objective of the pertinent clauses determining whether a design supports the more general goals of the pact.

A. Evaluating the Main Objective of a Transaction

The OECD Commentary on *Article 29 of the OECD Model Tax Convention*²⁴ makes clear that acquiring a tax benefit is sufficient that it is one of the main reasons; it is not necessary that the PPT have as its sole or major goal. Should tax benefits be the main determinant of the structure, the PPT could be triggered without reference to the exemption rule.

Actually, tax issues often guide corporate and financial decisions. Therefore, evaluating whether the non-tax justifications of a transaction exceed its tax advantages depends much on the ***“reasonableness test”***.²⁵ This examination looks at the more general commercial justification to ascertain if the arrangement's tax advantage served more as an incidental or main goal.

²⁴ Organisation for Economic Co-operation & Development, *Model Tax Convention on Income and on Capital*, art 29(9).

²⁵ IRAS e-Tax Guide (Second Edition), *Avoidance of Double Taxation Agreements (DAs)*, Inland Revenue Authority of Singapore (2017).

The exception rule: test of object and purpose

If the issuance of the treaty benefit aligns with the objective and intent of the pertinent Covered Tax Agreement (CTA), the PPT is useless. This calls for determining the particular treaty clauses under issue and examining their more general meaning.

To interpret the object and purpose of a treaty provision, various sources must be considered, including:

- The **text of the provision**, analysed in the context of related treaty provisions.
- The **treaty preamble**, which often clarifies the overarching goals of the agreement.
- **Extrinsic materials**, such as explanatory memoranda and official commentaries (provided they are not subject to reservations).

Though it offers a basic framework for interpretation, treaty text by itself might not fully express the intended intent and purpose. When the language is vague, one should consider the more general goals of the treaty—such as assigning taxing rights evenly across contracting parties and avoiding double taxation.

This new preamble acts as a guiding concept for implementing the exception rule as the MLI changes treaty preambles to clearly express that tax treaties are meant to eradicate double taxation while limiting tax evasion and avoidance.

C. Burden of Proof: A Standard Out of Proportion?

The PPT raises serious questions about the distribution of the burden of proof. Clearly, the expectations of tax authorities against taxpayers are somewhat different:

- Tax authorities just had to come to a reasonable conclusion that a transaction's main goal was to get treaty benefits.
- On the other hand, taxpayers have to prove—convincingly—that allowing the benefit

fits the goal and intent of the treaty clauses.²⁶

This results in a lower threshold for tax authorities to reject treaty benefits and loads more evidentiary weight on taxpayers trying to defend their purchases.²⁷

Courts will ultimately have to decide whether a transaction satisfies the PPT standards depending on an objective fact-based review. Should doubt surround tax misuse, avoidance, or the artificial character of the arrangement, the benefit of the doubt should go to the taxpayer.

Chapter III. Deconstructing the Reasonableness Test in the Principal Purpose Test

Judicial rulings indicate that any purpose test should be evaluated based on objective manifestations of intent.²⁸ The phrase 'reasonable to conclude' in the PPT explicitly underscores this objective assessment, affirming that the purpose test in the PPT examines *not the specific taxpayer's mindset but what a reasonable taxpayer would perceive as the purpose of the transaction*.²⁹

The PPT rule applies where it is fair to conclude that a benefit conferred by a tax treaty was one of the major aims of any arrangement or transaction. This requirement comprises two components: the reasonableness test and the major purpose test.

The PPT rule applies where it is reasonable to determine, considering all pertinent facts and circumstances, that acquiring such advantage was one of the primary objectives of any arrangement or transaction.

The phrase '*it is reasonable to conclude, having regard to all relevant facts and circumstances*' is the 'reasonableness test.' Points 10 and 11 in the Commentary on the PPT rule in the final report on Action 6 are significant for the application of the reasonableness test in the PPT rule.

Reasonableness standards are prevalent in common law systems;³⁰ for instance, they are

²⁶ Joris Luts, *BEPS Action 6: Tax Treaty Abuse*, Intertax (2015), <https://doi.org/10.54648/taxi2015011>.

²⁷ Canada Trustco Mortgage Co. v. Canada, (2005) 2 S.C.R. 601.

²⁸ Robert Danon, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, International Bureau of Fiscal Documentation, https://serval.unil.ch/resource/serval:BIB_C4BF952C7C7F.P002/REF.pdf (2018).

²⁹ OSFC Holdings Ltd. v. Canada, [2001] F.C.J. No. 1381.

³⁰ Paulo Rosenblatt, *General Anti-avoidance Rules for Major Developing Countries*, Kluwer International Law (Business & Economics) (2015),

incorporated in the General Anti-Tax Avoidance Rule (GAAR) of the UK, Australia, Canada, and South Africa.

Incorporating a reasonableness test within a GAAR objectifies the subjective intention that acquiring a tax benefit was the primary purpose of a transaction; to ascertain a taxpayer's or arrangement's subjective intention, an objective analysis of the factual circumstances must be conducted.³¹

The reasonableness test is an objective assessment, as explicitly stated in the Commentary to the PPT:

To ascertain whether one of the principal purposes of any individual involved in an arrangement or transaction is to secure benefits under the Convention, it is essential to conduct an objective analysis of the intentions and objectives of all parties engaged in establishing that arrangement or transaction. The purposes of an arrangement or transaction are factual enquiries that can only be determined by examining all facts surrounding the arrangement or event on an individual basis.

Point 11 of the Commentary states that all pertinent facts and circumstances (the evidence) 'must be evaluated to ascertain whether it is fair to assume that an arrangement or transaction was executed or organised for such purpose.' We believe that substance can only be attributed to the phrasing and can be 'weighed' when the tax authorities provide a rationale in the assessment explaining the interrelation of the various facts and situations.³²

This exam is not a simple test. This is also highlighted in the Commentary. It is noted that one should not hastily presume, and it is emphasised that simply examining the consequences of a structure typically does not allow for a determination of its objectives.

We believe this indicates that tax authorities cannot presume that a tax benefit is the primary objective of an arrangement designed to secure a treaty benefit, nor can they solely emphasise

https://books.google.co.in/books/about/General_Anti_avoidance_Rules_for_Major_D.html?id=tGe5rQEACAAJ&redir_esc=y.

³¹ Craig Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All?*, World Tax Journal – Auckland (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3346660.

³² Dennis Weber, *The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law*, Erasmus Law Review (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3026302.

the outcomes in their evaluation to conclude that the principal aim of an arrangement is to acquire a treaty benefit. The tax authorities may not identify a substantial tax advantage and thereafter conclude that securing that advantage was a primary objective of an arrangement or transaction. Conversely, the taxpayer cannot simply claim this. It is noted that a person cannot evade the enforcement of this paragraph just by claiming that the arrangement or transaction was not executed or structured to secure the advantages of the Convention.³³

It is insufficient to only confirm the existence of the subjective aspect, namely, the taxpayer's intention to establish a structure primarily aimed at securing a benefit outlined in a Tax Treaty; it is also essential to assess the objective criterion of the PPT rule. Within this framework, two salient elements must be emphasised:

- (i) The subjective component of the GAAR examines the taxpayer's intentions, while the objective component evaluates the objectives of the Tax Treaty; and
- (ii) the subjective aspect necessitates merely a reasonableness assessment, allowing the tax authority to recognise the potential for abuse, whereas the objective criterion mandates that the tax arrangement in question adheres to the stipulations of the Convention.³⁴

In this context, it is important to highlight that BEPS Action 06 has established an explicit stipulation as one of the fundamental strategies to address treaty shopping, asserting that governments would not facilitate chances for evasive or avoidance actions. The authors assert that the reasonableness test necessitates the tax authorities to conduct an objective review based on all facts and circumstances, determining that gaining a benefit is one of the primary aims of an arrangement.

Chapter IV. Can the Indian framework uphold the principal purpose test?

The Income Tax Act of 1961 ("ITA") in India has instituted GAAR, beginning from April 1, 2017. These regulations have been enacted to avert the exploitation of tax planning strategies

³³ Irma Johanna Mosquera Valderrama, *BEPS principal purpose test and customary international law*, Leiden Journal of International Law (2020), https://globtaxgov weblog.leidenuniv.nl/files/2020/06/beps_principal_purpose_test_and_customary_international_law.pdf.

³⁴ *Supra Note* at 19.

that result in unwarranted tax evasion. The legitimacy of structures and arrangements holds significant relevance from a tax standpoint. The GAAR provisions apply if tax authorities determine that the major objective of an arrangement, participant in a transaction, or step within a transaction is to get a tax benefit, and there is no business substance or urgency beyond securing that advantage. **In such circumstances, the arrangement will be deemed an unacceptable tax evasion strategy.** This may lead to several repercussions, including, but not limited to, the denial of any tax benefits under the relevant tax treaty, and the conversion of debt into equity, and vice versa.

The Indian Supreme Court emphasised the significance of certainty in tax law and the rule of law in the notable case of *Vodafone International Holdings v. Union of India*.³⁵ Justice Kapadia noted:

“Legal doctrines such as ‘limitation of benefits’ and ‘look through’ pertain to policy considerations.” The Government must incorporate them into the Treaties and laws to prevent conflicting interpretations. Investors must ascertain their position. It also assists the tax administration in executing the stipulations of the tax laws.

The Supreme Court's ruling in Vodafone predates the OECD's BEPS initiative. The Court explicitly said in its conclusion that “*anti-abuse provisions cannot be incorporated into tax treaties and are to be left to Parliament for tax treaty policy.*”

This view was substantially consistent with the decade-old ruling in *Azadi Bachao Andolan v. Union of India*.³⁶ In both instances, the Supreme Court observed that “Parliament should implement sufficient provisions in domestic law or tax treaties to prevent companies from exploiting tax regulations for their advantage.”

The Indian Supreme Court, in *Chief Settlement Commissioner v. Om Parkash*,³⁷ stated that “the central and most defining aspect of our constitutional system is the rule of law, which signifies the courts' authority to evaluate all administrative actions against the criterion of legality.”

³⁵ Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.

³⁶ Union of India v. Azadi Bachao Andolan, (2003) 263 IT 706.

³⁷ Chief Settlement Commissioner v. Om Prakash (1968) SCC OnLine SC 95.

In the recent case of *Indostar Capital v. ACIT*,³⁸ the Bombay High Court rejected the Mauritius treaty benefit concerning the sale of shares in an Indian business purchased before April 1, 2017. Nonetheless, the High Court permitted the revenue to scrutinise the authenticity of the transaction during the assessment processes, asserting that "*the mere fact that the assessee company has not engaged in any other business independently may not be definitive...*"

The assertion that the simple transfer of funds via banking channels is insufficiently conclusive may be valid; however, it cannot serve as a basis for action against the assessee in the absence of detrimental evidence.

The magnitude of administrative expenditures and the employment structure may contribute to determining if the transaction was a sham and if the assessee's existence was fraudulent; nevertheless, these considerations alone may not be adequate.³⁹

The High Court has recognised the necessity to scrutinise the issue during assessment proceedings; thus, findings by the Assessing Officer following the PPT may be deemed adequate to infer that a principal purpose of the transaction is to secure a tax benefit.

Consequently, the onus of evidence finally transfers to the taxpayer or the deductor in this instance, since they must demonstrate that the tax benefit aligns with the intent and purpose of the applicable laws.

The Indian judiciary has always asserted that the tax administration must not operate arbitrarily or capriciously. All actions undertaken by the tax authorities must be logical and justified. According to the PPT, the tax authority may reject tax benefits if it is fair to determine, considering all pertinent facts and circumstances, that securing such benefit was one of the 'primary aims' of any arrangement or transaction that directly or indirectly led to that benefit.

The tax authority's decisions must not only be rational but also grounded in a solid foundation. Conclusions must be founded on objective, clearly defined factors rather than the subjective satisfaction of the tax authority.⁴⁰

³⁸ *Indostar Capital v. ACIT* (2019) 415 ITR 513.

³⁹ *Id.*

⁴⁰ Ashish Goyal, *Does the Principal Purpose Test (PPT) Throw Tax Certainty to the Winds?*, Kluwer International Tax Blog (2019), <https://kluwertaxblog.com/2019/05/02/does-the-principal-purpose-test-ppt-throw-tax-certainty->

Apparent Issues Concerning the PPT

The issue with the PPT is the determination of what constitutes "relevant facts" and "relevant circumstances"; clearly, this is not the prerogative of the taxpayer. What constitutes the standard of "reasonableness"? And from whose perspective is "reasonableness" determined? How does the tax authorities determine, after examining the pertinent facts and circumstances, whether a case is reasonable or unreasonable? Where is the direction?⁴¹

If one of the primary aims, albeit not the predominant reason, was to secure a tax advantage, the tax authorities may reject treaty benefits. A thorough list of examples illustrating when a transaction was executed with the major goal of generating a tax benefit is absent. This indicates that if a legitimate commercial rationale was among the primary objectives of the transaction, the PPT would still be applicable. Is it not somewhat simplistic for the tax authority to demonstrate that one of the primary objectives was to secure a tax advantage?⁴²

Additionally, Article 7 stipulates that a treaty benefit shall not be denied if it is demonstrated that granting the advantage aligns with the objectives and purposes of the tax treaty. What criteria would the court evaluate to ascertain if the tax authority has fulfilled its burden of proof? Should the taxpayer assume the principal burden of proof in tax-related issues? Will the court analyse the Preamble of the tax treaty, a specific article of the treaty, or both? What occurs if a tax treaty does not explicitly forbid treaty shopping?

Notably, the PPT inside the MLI may, in certain instances, have a wider scope than the GAAR under the ITA, as the latter is activated just when the "main purpose" of the arrangement is to secure a tax advantage. Additionally, for GAAR to be invoked, one of the other compromised criteria must also be fulfilled, namely, the establishment of rights or duties that are not conducted at arm's length, exploitation of the ITA, absence of commercial substance, or lack of good faith. Consequently, it is improbable for the GAAR to be invoked if the PPT is satisfied, unless circumstances arise where the PPT is circumvented on the basis that the benefit aligns with the intent and purpose of the treaty provision.⁴³

to-the-

winds/#:~:text=There%20is%20a%20possibility%2C%20therefore,apply%20the%20anti%2Dabuse%20rule.

⁴¹ *Id.*

⁴² *Supra Note* at 16.

⁴³ *Supra Note* at 13.

The ITA establishes procedural protections for the use of GAAR, requiring approval from a panel led by a current or former High Court judge, alongside one Revenue officer and an academic or scholar. Ironically, there are no protections in place for the activation of the PPT, which is, in fact, a more comprehensive and subjective assessment. Authors evidently believe that domestic norms are necessary to establish a framework for the exercise of such extensive subjective authority. To provide essential information and alleviate taxpayer apprehensions.⁴⁴

The authors contend that tax treaties ought to include an anti-abuse provision. This provision is not only advantageous but also necessary to mitigate concerns regarding tax treaty override in the context of domestic anti-abuse legislation. The existence of a treaty abuse regulation and adherence to its stipulations would constitute a robust defence against the enforcement of a domestic anti-abuse rule.

Conversely, such regulations must not be capricious or ambiguous and must adhere to the principles of tax clarity and equity.

The PPT does not seem to exist. The implementation of PPT may substantially influence investments from nations including Singapore, the Netherlands, Ireland, the UK, and Cyprus. Subsequent to revisions of India's tax treaties with Mauritius, Singapore, and Cyprus, capital gains derived from the transfer of shares in an Indian firm are now liable to Indian taxation. ***The India-Netherlands tax treaty permits exemption from Indian capital gains tax under certain conditions. Residents of Mauritius, Singapore, and Cyprus remain eligible for relief under their respective tax treaties concerning capital gains from the transfer of instruments other than shares in Indian companies, including debt instruments, or the sale of shares in a foreign company that possesses shares in an Indian target company.*** Nevertheless, these reliefs will now be contingent upon satisfying substantive requirements outlined in their respective tax treaties (where applicable), in addition to the constraints imposed by GAAR and PPT regulations under domestic law and the MLI.

PPT is also pertinent for other revenue kinds, like royalties and fees for technical services (FTS), which previously required simply the beneficial ownership (BO) test. *If the Principal Purpose Test (PPT) is not met, it may invalidate the tax treaty, encompassing the more limited definitions of royalty and fees for technical services (FTS). While the objective of PPT is*

⁴⁴ *Id.*

laudable, it provides tax authorities with an additional subjective instrument to overlook the structure of cross-border arrangements, recharacterize their substance, and deny tax treaty advantages, alongside the existing anti-avoidance provisions in Indian tax treaties and the IT Act, potentially resulting in heightened uncertainty and an escalation in tax litigation.

Chapter V. Principal Purpose Test – Government Clarifies Its Application

India implemented several significant adjustments into her tax treaties, signatory to the Multilateral Convention to Implement Tax Treaty Related Provisions to Prevent Base Erosion and Profit Shifting (MLI). Among the most significant developments is the Principal Purpose Test (PPT), which denies treaty advantages if one of the principal objectives of an arrangement or transaction was to gain such benefits.

While India's General Anti-Avoidance Rule (GAAR) focused notably on transactions meant primarily for tax gain, the PPT covers greater scope. Denying treaty advantages under the PPT could have significant tax implications since Indian tax law specifies that the most beneficial provision between the Income Tax Act, 1961 (ITA) and tax treaties applies.

Modern Tax Treaty Case Methodologies

October 1, 2019 saw the MLI adopted for India; Indian tax authorities (ITD) have only provided minimal administrative guidance on how the PPT should be used. Sometimes denials of treaty benefits have been justified without thought to whether admitting them would satisfy the "object and purpose" of the treaty—a basic protection under the PPT.

Recently ruling against this indiscriminate PPT application was the Income Tax Appellate Tribunal (ITAT).⁴⁵ The panel stressed that before rejecting such benefits, the ITD had to show "cogent and convincing evidence" establishing that an arrangement exists merely to gain treaty benefits.

On January 21, 2025 the Central Board of Direct Taxes (CBDT) published a Circular Offering Guidance on the PPT's application.⁴⁶ Only those of bona fide transactions involving actual commerce, services, and capital movements—benefits from treaties—should find the PPT

⁴⁵ SC Lowy P.I. (Lux) S.A.R.L. v. ACIT, order dated 30.12.2024 in ITA No. 3568/Del/2023.

⁴⁶ Circular No. 01/2025 dated 21 January 2025, F. No. 500/05/2020/FT&TR-II.

appropriate.

The PPT will be accessed depending on objective facts and a case-specific assessment of relevant elements. Once the ITD discovers that obtaining a treaty benefit was one of the primary objectives of a transaction, the obligation shifts to the taxpayer to prove the benefit matches the objective of the treaty.

Under the MLI or a bilateral treaty modification, the PPT will apply only from the day the tax treaty provision including it enters effect.

clauses pertaining to grandfathering: The PPT has no influence on treaty-specific commitments India made to Mauritius, Singapore, Cyprus, or other nations including grandfathering terms under those treaties. Subject to India's concerns, the ITD could further review the BEPS Action Plan 6 Final Report and the UN Model Tax Convention (2021) for additional interpretation.

The Circular is a major turning point in deciding future PPT usage direction.

Two main clarifications leap out:

Prospectively, the PPT assures that it has no effect on pre-existing, grandfathered businesses under ongoing investigation on issues including beneficial ownership and economic substance. As CBDT circulars bind on the ITD, this guidance is supposed to facilitate a more measured and consistent response in treaty-related conflicts.

Still, there are few gaps and ambiguities including:

1. Arbitrary definition of "relevant" facts and conditions

The circular leaves unanswered what information would be deemed "relevant" for using the PPT. Indian courts claim that occasionally a tax residence certificate (TRC) by itself is not enough. Recent ITD statistics point to factors including features of ownership structure, management control, substance in the home jurisdiction, source of funding, and income utilisation helping to assess PPT claims.

2. Taxpayers' Burden of proof

Once the ITD discovers that the major objective of the arrangement was to get a treaty benefit,

the Circular passes the responsibility of evidence to taxpayers. Still up for debate, though, is: What constitutes "relevant provisions"? When deciding whether a transaction aligns with treaty objective and intent?

Whether the assessment covers the whole treaty or only the specific paragraph granting the tax advantage. The MLI offers preamble material promoting anti-tax evasion purposes, thus the Circular seems to adopt a broad reading, considering the broader goal of the treaty rather than merely the specific provision granting the advantage.

3. Use Against India-Mauritius Treaty

Although the MLI has before inserted the PPT into India's tax treaties with Singapore and Cyprus, its application to the India-Mauritius treaty is currently under review. The PPT under this treaty will not be relevant until India properly announces them, the ITAT had earlier concluded.

4. Reliance on OECD and UN Guidelines: Two-Edged Blade

Authorising the ITD to consult the UN Model Tax Convention and the BEPS Action 6 Final Report will assist to clarify things but also generate possible conflicts. These sources provide guidelines for assessing tax evasion, but they also feature contested interpretations that could motivate more cases.

5. Danger in Expanding Anti-Abuse Policies Outside the PPT

The Circular does not solve the ITD's proclivity to read in beneficial ownership and substance requirements even in circumstances when treaty provisions do not plainly demand them. This allows room for court anti-abuse policies to be applied outside the PPT, particularly in grandfathered cases covered by the Mauritius and Singapore treaties. But Indian courts have always set a high benchmark for denying treaty benefits basing simply on substantive criteria alone.

The Circular provides first guidance on the ITD's approach to the PPT, therefore highlighting that treaty advantages should complement the core objectives of enabling genuine economic activity. More clarity is still needed, though, on specific circumstances when the PPT will not

apply instead of letting judgements be entirely left to case-by-case interpretation.⁴⁷

Taxpayers without economic substance or deriving funds from third-country sources could be denied treaty advantages until judicial precedents clarify precise rules on the PPT, therefore generating lengthy litigation and uncertainty.

Chapter VI. Conclusion and Future Considerations

As this project has shown, the Principal Purpose Test (PPT) as it is now set offers both conceptual and pragmatic difficulties. Although the PPT fits current international initiatives to reduce treaty misuse, its formulation presents questions—especially with regard to its subjective element, which can be vague, broad, and vulnerable to arbitrary interpretation. Many times, the objective side of the PPT dominates the subjective component, which makes its implementation difficult and dubious.

Now considering the PPT, taxpayers have to review their current systems and upcoming transactions. Practically, though, deciphering its main components could prove challenging. Although OECD recommendations provide some clarity by means of examples, their persuasive efficacy is nevertheless restricted in practical contexts. The "*Object and Purpose*" test of tax treaties should be given more weight since it offers opportunity for exemption from the rigorous PPT application.

Applying the Multilateral Instrument (MLI) and, more especially, the PPT depends on a sensible and pragmatic attitude from tax authorities. This approach should ideally target only those clearly abusive or artificially designed arrangements meant for tax evasion. The PPT's application across several tax treaties—with differing interpretations across jurisdictions—adds more complexity, much as the advent of General Anti-Avoidance Rules (GAARs) in home tax laws presented issues for tax practitioners.

Fundamentally, the PPT seeks to stop aggressive tax planning by international companies and people. If extensively used, it might give tax authorities a more efficient weapon to question such systems instead of protracted treaty negotiations. Still, the complexity of the MLI presents a difficulty, especially for underdeveloped countries that would find its execution taxing.

⁴⁷ Rajesh Simhan, *Tax Treaties And The Principal Purpose Test – Government Clarifies Its Application*, Worldwide (Feb. 3, 2025), <https://www.mondaq.com/india/tax-authorities/1577842/tax-treaties-and-the-principal-purpose-test-government-clarifies-its-application>.

Acknowledging the PPT as a pillar of customary international law could provide nations with a more consistent means of addressing tax avoidance, therefore promoting fairer taxation, and allowing them to create money for necessary public services.

Effective functioning of the PPT depends on well-defined implementation rules, especially concerning the discretionary authority of tax authorities. Lack of such clarity could result in erratic tax court decisions from uneven implementation. Developing domestic systems that define the subjective component of the PPT would help to increase confidence among investors and taxpayers.

Adoption of the MLI is probably going to complicate business operations in the short to medium term before a steady framework develops. Simplifying the PPT's application will help to guarantee that both tax authorities and taxpayers may negotiate the rules more successfully. Moreover, more global collaboration is necessary for information-sharing on cross-border transactions, so guaranteeing a consistent application of the PPT over countries. Furthermore implemented should be efficient monitoring and enforcement systems to support the primary goal of the PPT: preventing tax abuse while preserving a fair and predictable tax environment.