


Indian Tribunal Reaches Tax Treaty Interpretation Milestone

by Bijal Ajinkya, Viraj Doshi, and Aanchal Jain


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In this article, the authors explain why a recent decision by the Indian Income Tax Appellate Tribunal sets an important precedent for tax treaty interpretation.

Eligibility for tax treaty benefits under Indian tax law has been the subject of extensive judicial scrutiny.

A recent ruling by the Indian Income Tax Appellate Tribunal in *SC Lowy P.I. (LUX) S.A.R.L.*¹ provides crucial insight into the application of the principal purpose test (PPT) under Indian tax treaties. The tribunal examined the substantive

application of the PPT and ultimately ruled in favor of the taxpayer, granting benefits of the India-Luxembourg Double Taxation Avoidance Agreements. This decision is significant because it creates judicial precedent in India to adjudicate on PPT provisions, offering valuable interpretational guidance for taxpayers and tax authorities.

Introduction

Under Indian tax law, a nonresident taxpayer seeking to claim tax treaty benefits must provide a valid tax residency certificate (TRC) issued by the tax authorities of their home country. The Supreme Court (the apex court in India) in the landmark decision of *Azadi Bachao Andolan*² affirmed that TRCs are conclusive proof of residency to claim tax treaty benefits. However, Indian tax authorities have frequently denied treaty benefits based on the facts of certain cases even when a TRC was submitted,³ contending that taxpayers have established conduit entities solely for the purpose of availing themselves of such benefits.

The PPT also serves as a key antiavoidance provision introduced under tax treaties amended by the multilateral instrument — for example, India's treaties with Singapore, the Netherlands, and Cyprus — or through bilateral negotiations with certain jurisdictions like China, Hong Kong, and Chile. The PPT stipulates that a taxpayer is not entitled to tax treaty benefits if it is reasonable to conclude that one of the principal purposes of the arrangement or transaction is to obtain these benefits, unless the taxpayer can demonstrate that

² *Union of India v. Azadi Bachao Andolan*, (2004) 10 SCC 1.

³ *Aditya Birla Nuvo Limited v. DDIT*, (2011) 12 taxmann.com 141 (Bombay); *AB Mauritius, In re*, (2018) 90 taxmann.com 182 (AAR — New Delhi); *Tiger Global International II Holdings*, [2020] 116 taxmann.com 878 (AAR — New Delhi).

¹ *SC Lowy P.I. (LUX) S.A.R.L. v. Assistant Commissioner of Income Tax*, ITA No 3658 / DEL / 2023.

granting the benefit is in line with the object and purpose of the treaty.

Facts of the Case

The taxpayer is a Luxembourg-based limited liability company and a subsidiary of a Cayman Islands-based entity. The taxpayer is a Category II foreign portfolio investor registered with the Securities and Exchange Board of India and has investments in its Italian subsidiary, bonds issued by an Indian company, and passthrough certificates issued by securitization trusts in India.

The taxpayer claimed the following tax treaty benefits under the India-Luxembourg treaty: (a) exemption of business income from securitization trusts (due to absence of permanent establishment under article 7 of the treaty) and (b) exemption of capital gains on sale of bonds and debentures, asserting that these gains were taxable exclusively in Luxembourg under the treaty. Further, the taxpayer also claimed a concessional 10 percent tax rate on interest income from alternative investment funds under the treaty.

Contention of the Tax Authorities

The tax officer denied the tax treaty benefits based on the following rationale:

1. The taxpayer has perpetrated a tax avoidance scheme through treaty shopping.
2. The taxpayer is merely a conduit and the real owners are the shareholders/investors who are tax residents of other countries (in this case, the Cayman Islands).
3. The TRC is not sufficient to establish tax residency if the substance is established otherwise.
4. The taxpayer is not a beneficial owner of income as it does not have control and dominion of its funds.
5. There is no commercial rationale of the taxpayer's establishment in Luxembourg as the commercial outcomes would be identical irrespective of location of funds.

The tax authorities also invoked the PPT provisions and alleged that a Cayman Islands holding entity set up a presence in Luxembourg only to claim the benefits under the treaty

(because there is no tax treaty between India and the Cayman Islands).

Ruling

The tribunal ruled in favor of the taxpayer, granting treaty benefits based on the following:

1. **Validity and sanctity of TRCs:** The tribunal relied on the *Tiger Global*⁴ ruling and Circular No. 789 of 2000 issued by the Central Board of Direct Taxes (CBDT), which affirms that the TRC is sacrosanct in determining fiscal residence and beneficial ownership. It affirmed that a valid TRC should not be disregarded and that it is a mechanism adopted by jurisdictions to dispel any speculation regarding residence of a taxpayer.

The tribunal asserted that the corporate veil of a taxpayer should not be pierced unless there is concrete evidence of fraud, the transaction is a sham, there is lack of economic substance, or the transaction is structured to camouflage illegality. The tribunal emphasized that CBDT Circular No. 789/2000, though originally issued for Mauritius, applies universally to all tax treaties, reinforcing that the TRC serves as sufficient proof of tax residency and beneficial ownership.

2. **Burden of proof on tax authorities:** The tribunal held that the onus to prove treaty abuse or tax avoidance is on the tax authorities. A mere presumption, suspicion, or perceived need for further investigation is insufficient to deny treaty benefits. The tax authorities must provide cogent and convincing evidence to establish treaty abuse before disregarding a valid TRC.
3. **Applicability of the PPT:** The tribunal noted that the taxpayer submitted a valid TRC and the tax authorities had not raised any objections regarding its validity. Further, the tribunal observed that the PPT would not apply to deny the tax treaty

⁴ *Tiger Global III Holdings v. Authority for Advance Rulings*, (2024) SCC Online Del 5987.

benefits to the taxpayer based on the following facts of the case:

- a. The taxpayer was incorporated in Luxembourg in 2015 as an investment holding company with a primary focus on distressed asset investments. The taxpayer continues to exist in Luxembourg and holds significant investments, further contradicting the claim of the tax authorities that it was a conduit entity.
- b. Apart from investing in Indian securities, the taxpayer also invested in its Italian subsidiary, demonstrating its global presence beyond India.
- c. In terms of geographical investment distribution, 86 percent of the taxpayer's investments were outside India, negating the argument that the entity was set up solely to exploit treaty benefits in India.
- d. The taxpayer incurred substantial operational expenditures in Luxembourg, including legal and professional fees, rent, bank charges, and accounting expenses, reinforcing its economic substance in India.
- e. SC Lowy Offshore Fund, Cayman Islands (the taxpayer's holding company) is a special purpose vehicle for pooling funds from multiple investors and the taxpayer itself was registered as a Category II — Foreign Portfolio Investor.
- f. The taxpayer filed tax returns and paid taxes in Luxembourg on its worldwide income, including income from Indian investments and other jurisdictions.

CBDT Circular

In a significant and welcome development, the Central Board of Direct Taxes (India's apex tax administration body), issued Circular No. 1 of 2025 on January 21 clarifying key aspects of the PPT under tax treaties. The circular clarifies that PPT provisions will apply prospectively, providing assurance to taxpayers. Further, it confirms that gains on the transfer of shares acquired by residents of Mauritius, Cyprus, and Singapore in Indian companies before April 1,

2017, will remain outside the purview of the PPT (in line with the provisions grandfathering clauses under the respective treaties), ensuring that these transactions are not subject to retrospective scrutiny.

Importantly, the circular emphasizes that PPT application is a context-driven, fact-specific exercise to be conducted on a case-by-case basis because there are no fixed parameters for testing its applicability.

Conclusion

Introducing the PPT under Indian tax treaties has made the demonstration of commercial rationale and economic substance a critical requirement for claiming treaty benefits. The circular reinforces the principle that PPT application remains largely subjective and context-dependent, necessitating case-by-case evaluation.

This case sets a significant precedent for interpreting the PPT and is expected to offer valuable guidance in similar cases moving forward. The tribunal considered several factors, including the purpose of establishing operations in Luxembourg, the taxpayer's substantially higher investments in other jurisdictions compared to India, and the considerable operational expenditures incurred, as sufficient indicators to satisfy the requirements of the PPT. This ruling should assist taxpayers in similar circumstances by helping them navigate the complexities of the PPT and assess their eligibility for tax treaty benefits. It reaffirms that legitimate business structures will not be unduly affected by the PPT. The decision underscores the importance of demonstrating the genuine intent behind business structures, ensuring alignment with the objectives and purpose of the treaty. Further, it highlights that while a valid TRC is essential, it alone may not fulfill the PPT requirements unless supported by adequate evidence.

The issue of eligibility for tax treaty benefits under Indian tax law remains a subject of extensive judicial scrutiny — the *Blackstone* ruling⁵ by the Delhi High Court also upheld the sanctity

⁵ *Blackstone Capital Partners (Singapore) VI FDI Three Pte. Ltd. v. ACIT*, (2023) 146 taxmann.com 569.

of TRCs, but it was challenged before the apex court, which granted a stay. It is important to note that while the tribunal has heavily relied on *Tiger Global*,⁶ the Supreme Court stayed its operation on January 24 and stated that it requires thorough consideration. ■

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⁶ *Tiger Global III Holdings v. Authority for Advance Rulings*, (2024) SCC Online Del 5987.