Does the Principal Purpose Test (PPT) Throw Tax Certainty to the Winds?

Author: Ashish Goel

May 3, 2018

In 1988, V. S. Ranganathan wrote a letter to the Financial Express which read: "Our Constitution is not written in a book, but in the mind of every citizen of this country. In effect, our Constitution is never written but is written in the way we understand it.

In 2013, in the wake of the global financial crisis, the OECD launched the BEPS project to address certain aspects of multinational tax planning. One of the key elements of this project was the introduction of the PPT. The PPT is a rule that allows the tax authority to deny treaty benefits if one of the principal purposes of a transaction is to obtain tax benefits.

According to the OECD, treaty shopping, one of the ways in which companies exploit tax rules, is one of the ways in which companies engage in tax avoidance.

A lot has been written about the PPT ever since the OECD proposed it. In fact, and as we might see in the near future, the tax authority may play a quasi-legislative function in applying the PPT. The consequence: the tax authority may have a free hand to apply the anti-abuse rule. This is worrisome especially given that the PPT is being introduced as a safeguard against tax avoidance.

Pertinently, the PPT is much broader than the Indian GAAR: GAAR uses the main purpose test. Besides, the PPT is a much broader test. It would still apply if genuine commercial reason was also one of the principal purposes of the transaction. Here again, is it not too easy for the tax authority to show that tax benefit was one of the principal purposes?

Next, the tax authority may deny treaty benefits if one of the principal purposes – and not necessarily all principal purposes – was to obtain tax benefit. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider?

As noted by the Indian Supreme Court in Chief Settlement Commissioner vs Om Prakash (1988), "in a constitutional system, the constitutional and constitutional principles are the reason of the law which reasons the authority of the court to test any administrative action to be the ideal of legality." It is not only necessary that the tax authority's conclusions be reasonable, but there has to be a sound basis for those conclusions. In other words, the tax authority must be able to show that the tax benefit would be in accordance with the object and purpose of the tax treaty.

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

Finally, the PPT makes tax treaty policy. As noted by the Indian Supreme Court in Chief Settlement Commissioner vs Om Prakash (1988), "in our constitutional system, the constitutional and constitutional principles are the reason of the law which reasons the authority of the court to test any administrative action to be the ideal of legality." In other words, the tax authority must be able to show that the tax benefit would be in accordance with the object and purpose of the tax treaty.

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

The problem with the PPT is who decides what are 'relevant facts' and 'relevant circumstances': certainly, the tax authority. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider?

Under the PPT, the tax authority may deny treaty benefits if one of the principal purposes – and not necessarily all principal purposes – was to obtain tax benefit. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

It is not only necessary that the tax authority's conclusions be reasonable, but there has to be a sound basis for those conclusions. These conclusions cannot be drawn based on the subjective satisfaction of the tax authority but only on objective, clearly stated facts.

The problem with the PPT is who decides what are 'relevant facts' and 'relevant circumstances': certainly, the tax authority. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

According to the OECD, treaty shopping, one of the ways in which companies exploit tax rules, is one of the ways in which companies engage in tax avoidance.

As noted by the Indian Supreme Court in Chief Settlement Commissioner vs Om Prakash (1988), "in a constitutional system, the constitutional and constitutional principles are the reason of the law which reasons the authority of the court to test any administrative action to be the ideal of legality." It is not only necessary that the tax authority's conclusions be reasonable, but there has to be a sound basis for those conclusions. In other words, the tax authority must be able to show that the tax benefit would be in accordance with the object and purpose of the tax treaty.

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

The problem with the PPT is who decides what are 'relevant facts' and 'relevant circumstances': certainly, the tax authority. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

It is not only necessary that the tax authority's conclusions be reasonable, but there has to be a sound basis for those conclusions. These conclusions cannot be drawn based on the subjective satisfaction of the tax authority but only on objective, clearly stated facts.

The problem with the PPT is who decides what are 'relevant facts' and 'relevant circumstances': certainly, the tax authority. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

The problem with the PPT is who decides what are 'relevant facts' and 'relevant circumstances': certainly, the tax authority. There is no illustrative list of instances that explain when a transaction would be denied treaty benefits if one of the principal purposes was to obtain tax benefit. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the relevant facts and circumstances that the tax authority would have to consider? Is it not too easy for the tax authority to show that the object and purpose of the tax treaty was to obtain tax benefit?