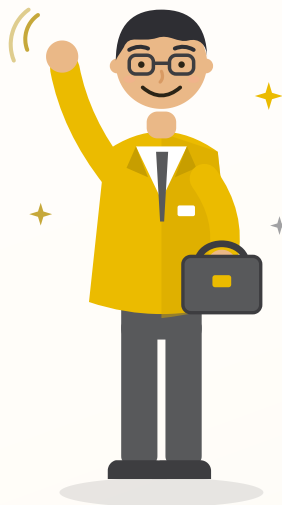




TAX ALERT · JULY 2026

India–Sri Lanka Tax Treaty: New Anti-Abuse Rule Now in Force

The Principal Purpose Test has arrived. Here is what it means for cross-border business
— explained simply, with real-life examples.



In force: 19 June 2026

Applies from: 1 April 2027

Tax rates: unchanged



Hello! I'm your Évolve tax guide. Here's the whole story in one line: from April 2027, treaty tax benefits between India and Sri Lanka can be **refused** if a structure exists mainly to obtain them. Real businesses are not affected. Let me show you around.

Summary Sheet

- **What happened:** a Protocol amending the 2013 India–Sri Lanka tax treaty is now in force.
- **Key change:** a Principal Purpose Test (PPT) – a rule against misuse of the treaty.
- **In force from:** 19 June 2026 · notified in India 16 July 2026 (Notification No. 88/2026).
- **Applies to income from:** 1 April 2027, in both countries.
- **Tax rates:** no change – only misuse is targeted.
- **Why it matters:** paperwork alone no longer secures benefits; real substance does.



🔍 Review needed if you...

- Hold Indian investments through a Sri Lankan (or third-country) entity
- Receive dividends, interest, royalties or service fees across this border
- Chose your structure mainly for the tax saving

✅ No concern if you...

- Trade genuinely between the two countries
- Have real operations, staff and premises
- Can show clear business reasons for your setup





Change 1 — A New Purpose Statement

“ REVISED PREAMBLE — EXTRACT

“...to eliminate double taxation ... without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Agreement for the indirect benefit of residents of third States)...”



In simple words: the treaty exists to stop the same income being taxed twice — not to help anyone pay tax nowhere. And it is not a back door for people from other countries.

Change 2 — The Principal Purpose Test

“ ARTICLE 28(6), AS AMENDED — EXTRACT

“...a benefit under this Agreement shall not be granted ... 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 ... unless ... granting that benefit ... would be in accordance with the object and purpose of the relevant provisions of this Agreement.”



In simple words: the tax officer can ask one question — “**was this set up mainly to get the tax benefit?**” If yes, the benefit can be refused. Even if all the paperwork is in order.

Do tax rates change?	No. All rates and reliefs stay the same.
Who decides “principal purpose”?	The tax authority — based on facts: staff, offices, operations, decision-making.
Is a tax residency certificate enough?	No longer, on its own. Real business substance is what counts.
Why was this done?	Both countries must meet the OECD/G20 global anti-abuse standard (BEPS Action 6). Sri Lanka hasn't signed the multilateral treaty (MLI), so it was agreed bilaterally. 

Three People, Three Outcomes

Case 1 · The Letterbox Company

BENEFIT DENIED**The Investor**

An investor abroad wants to invest in India. He registers a company in Colombo — no office, no staff, no business. Just an address. Money flows through it to India, and the returns claim the treaty's reduced rates.

Why denied: the Colombo company has one purpose only — the tax benefit. Under the PPT, India can refuse it and tax the income at full rates. This is the “treaty shopping” the Protocol targets.



Case 2 · The Real Exporter

BENEFIT PROTECTED**The Exporter**

A garment maker in Katunayake runs a factory with 500 workers and sells to Indian buyers. She claims treaty relief on her Indian income.

Why protected: the company exists to make garments, not to collect tax benefits. Nothing changes for businesses like hers — the treaty applies in full, as before.



Case 3 · The Regional Holding Company

NEEDS DOCUMENTATION**The Group CFO**

A group holds its Indian subsidiary through a Sri Lankan holding company with a small office and two staff, which also manages the group's Maldives operations.

Why borderline: there are real business reasons — but tax was likely one factor too. The safe course: record the commercial reasons in board minutes and business plans **now**, and make real decisions in Sri Lanka. If challenged, that paper trail is the defence.



The pattern is simple: substance wins, paperwork alone loses, and mixed cases turn on what you can prove. India learned this from its Mauritius experience — and is closing the same door here before it opens.



You Have Until April 2027. Use It.

The rules apply to income earned from 1 April 2027. That is the window to get ready.

- ✓ **List** every entity and transaction relying on India–Sri Lanka treaty relief — dividends, interest, royalties, service fees, capital gains.
- ✓ **Ask the PPT question honestly:** would each one exist without the tax benefit?
- ✓ **Build the evidence** — board minutes and business plans recording the business reasons. Now, not after a tax query arrives.
- ✓ **Fix or unwind** anything that stands mainly on the tax benefit.
- ✓ **Stay updated** — further official guidance on the PPT is expected.

The Journey So Far — and What's Ahead



Questions? We're one call away — let's review your structure together!



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