
CONUNDRUM IN INTERPRETING DTAA: A CRITICAL ANALYSIS

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Introduction:

DTAA serves as a blueprint document which distributes and demarcates tax responsibility between the residents of two countries. History of DTAA's relates back to the Austro-Hungarian empire (Prussia empire). DTAA were historically based on the principle of reciprocity where certain commercial advantages were granted to citizens on equal basis. After the conclusion of the WWII, the league of nations took specific interest in international taxation and made efforts to curb the burden of double taxation on the taxpayers. The efforts were reinforced by the Organization for Economic Cooperation and Development (OECD) which laid the foundation for model tax convention for its members.

India has one of the largest networks of DTAA with over 94 established comprehensive and is planning to sign more in the future. OECD along with G20 developed BEPS action plan which stands for Base Erosion and Profit Shifting which includes series of actions to address the gap in international taxation. BEPS action plan 6 introduced the term Principal Purpose Test (PPT) allowing countries to amend their DTAA and adopt to the PPT clause.

To adopt the BEPS action plan, India and Mauritius signed a new Protocol on March 7, 2024, revising the Double Taxation Avoidance Convention (DTAC) between the two countries. Key amendments, aligning with the minimum standards under BEPS, include:

- Principal Purpose Test (PPT) Introduction – The PPT clause, consistent with the Multilateral Instrument (MLI), must be met to qualify for the benefits under the DTAA.

This research paper aims to explore and trace the evolution of the Principal Purpose Test (PPT) as an anti-abuse provision within international tax treaties, with a focus on its incorporation under the OECD's Base Erosion and Profit Shifting (BEPS) Action 6 and its application in various Double Taxation Avoidance Agreements (DTAAs). In particular, this paper addresses the interpretational challenges and complexities that have emerged as countries implement the PPT to counter treaty abuse, often leading to inconsistencies in treaty application and disputes over its subjective nature. By investigating these issues, the research sheds light on the conundrum of interpreting DTAAs in light of the PPT and offers insights into how these interpretations impact cross-border transactions and tax policy.

Significance of DTAA:

Double Taxation Avoidance Agreements (DTAAs) are treaties between countries intended to prevent the problem of double taxation, where the same income is taxed by two jurisdictions. These agreements aim to provide taxpayers with relief by establishing rules to avoid or reduce dual taxation on cross-border income. In India, the legislative framework for addressing double taxation is found in Chapter IX of the Income Tax Act, 1961, which contains specific provisions to implement DTAAs and ensure that residents of treaty partner countries do not face double taxation on the same income.

DTAAs are designed to ease the burden of double taxation by providing exemptions or tax credits for taxes paid in one of the two contracting countries, thereby reducing or eliminating duplicate tax liability on the same income. These agreements are primarily guided by principles from the model draft developed by the Organization for Economic Cooperation and Development (OECD), although they often include modifications negotiated by the participating countries. The applicable tax rates for income covered by DTAAs are specifically determined by the terms of each agreement, ensuring a mutually accepted framework for taxation between the countries involved.

Historical evolution of DTAA

The concept of Double Taxation Avoidance Agreements (DTAAs) has deep historical roots, with its origins tracing back to the late 19th century. The first formal DTAA was established in 1899, by forming a treaty between Prussia and the Austro-Hungarian Empire to address cross-border tax issues. The concern of double taxation, however, has been evident for centuries, dating as far back as the 13th century. Countries like France and Italy historically grappled with the complexities of taxing property owned by residents of one nation but situated within the territory of another. These early challenges laid the groundwork for modern DTAAs, which seek to alleviate double taxation and foster international economic cooperation.

India began its efforts to address double taxation in 1939 with the establishment of the Income-tax (Double Taxation Relief) Rules. Recognizing that DTAAs are agreements between sovereign states, a standardized approach was deemed beneficial, leading to the idea of a Model Agreement as a framework for negotiations. The League of Nations introduced the first Model Bilateral Convention in 1928, which was followed by the Model Convention of Mexico in 1943 and the London Model Convention in 1946. Subsequently, the Organisation for European Economic Co-operation (later the OECD) established an expert committee in 1956 to develop

a comprehensive Model Convention. This effort culminated in the 1977 OECD Model Convention and its Commentaries, which have been updated periodically, with the latest version available as of January 2003. Although originally intended for OECD member countries, the OECD Model Convention is widely referenced by non-member countries when interpreting tax agreements. Additionally, the UN Model Convention, created in 1980, serves as a guideline for DTAAs between developed and developing countries, emphasizing the source state's taxation rights in international transactions, a benefit for developing countries. Overall, the establishment of DTAAs and Model Conventions has been instrumental in addressing double taxation and creating a fair framework for international tax policy.

The Vodafone Case: Setting precedents for others

The Vodafone case is a landmark in understanding the complexities of interpreting Double Taxation Avoidance Agreements (DTAAs) in India, especially concerning cross-border transactions and capital gains tax. This case, which revolved around the taxability of Vodafone's indirect acquisition of Indian assets through an offshore transaction, highlighted key issues in DTAA interpretation, such as the definition of terms like "capital gains" and the scope of tax rights between countries. The Supreme Court's ruling, followed by retrospective amendments by the Indian government, underscores the challenges and evolving nature of DTAA interpretations in light of tax policy amendments—making it a significant case for examining interpretative conundrums within DTAAs.

Background of the case

There were four companies involved in this case. The first company, which was also the appellant in this case was Vodafone International Holdings Ltd. (Dutch based telecom company), second one was Hutchison Telecommunications International Limited (HTIL), Hong Kong based company. Third one was CGP investments limited (situated in Cayman Islands- Tax haven country) and the last one was Hutchison Essar limited (Indian based telecom company that was operating its business in India). CGP Investments Ltd was a 100% subsidiary¹ of the parent company-HTIL and HTIL held 100% shares in the CGP Investments Ltd.

Further, CGP Investments held 67% shares in Hutch Essar Ltd which was an Indian based company. Therefore, ultimately HTIL (Hong Kong based) was the parent company that was

¹ Indulia, Bhumika, and Ridhi. "Vodafone versus India: A Never-Ending Saga." *SCC Times*, 16 Sept. 2023, www.sconline.com/blog/post/2022/11/29/vodafone-versus-india-a-never-ending-saga/.

controlling indirectly CGP Investments and HEL. In 2007, HTIL decided to sell its Indian telecom business by selling its HEL and at the same time Vodafone was interested in starting its telecom operations in the Indian market. Therefore, in order to enter the Indian market, Vodafone decided to acquire HEL. However, rather than buying HEL directly, Vodafone decided to acquire CGP Investments which was situated in Cayman Island (tax haven country) and by acquiring CGP investments, they got control over the 67% shares in the HEL² and indirect control over the HEL. In this way, Vodafone managed to enter the Indian market without paying any taxes to the Indian income tax authorities.

The dispute arose when the Income Tax authorities, sent a show cause notice (SCN) to the Vodafone seeking explanation for not paying capital gain tax on the acquisition of CGP investment. The department contested that Vodafone was liable to deduct TDS of Rs 22,1004 Cr on capital gains under section 9 of the Income Tax Act, 1961 for the purchase of CGP investment. On the other hand, Vodafone contested, that Indian tax authorities did not have the jurisdiction to levy capital gain tax on the said transaction as the said entire transaction was outside the scope of s.9 of the Income Tax Act, 1961 because both the entities that were involved in the transactions i.e. Vodafone and CGP Investment Ltd were foreign based.

In the Vodafone case, Article 13 of the India-Mauritius Double Taxation Avoidance Agreement (DTAA) was a key focus. Article 13 addresses the taxation of capital gains and outlines which country has the right to tax gains from the transfer of assets. Vodafone argued that, under Article 13, capital gains arising from the transfer of shares in a foreign company (even if it indirectly involved Indian assets) were not taxable in India if the seller was a Mauritius resident. This interpretation sparked debate over India's taxing rights under the DTAA, ultimately leading to retrospective amendments in Indian tax law to cover such indirect transfers.

What did the Supreme Court Say?

After hearing both the parties, The Bombay High Court ruled in favour of the Income Tax authorities, holding Vodafone accountable for withholding taxes from payments made to HTIL because the transaction's primary element involved a change in controlling interest in an Indian company that served as a source of income for the company. The 'Vodafone' had a connection to Indian jurisdiction through the various agreements it signed. Consequently, it could not be

² "The \$ 2bn Vodafone Tax Saga: Taxsutra." Trusted Online Tax Information, www.taxsutra.com/microsites/vodafone. Accessed 12 Nov. 2024.

argued that procedures started by income-tax authorities lacked jurisdiction³. Accordingly, by initiating the proceedings against the Vodafone for failing to deduct tax at source, Indian Tax Authorities have acted within their jurisdiction. It was held that because of the transfer, the composition, management and control of an Indian company was being changed. Therefore, Vodafone was liable to deduct TDS on the transaction. It was further held that any profit or gain arising from the transfer of a company in India has to be considered as a profit and gains of the company which actually owns and controls it. In this case, the income from the transfer is accrued by the HTIL and not Cayman Island Company (CGP). Therefore, the interest of the recipient is divested to the petitioner and hence is liable for capital gains tax. Aggrieved by the decision, the Vodafone filed an appeal in the Supreme Court. In January 2012, the Supreme Court after hearing both the sides, reversed the judgement of the Bombay High Court and held that the current transaction was neither a tax evasive transaction nor a fiscal nullity. The SC held that the said transaction was outside the scope of s.9 of the Income Tax Act, 1961 and since neither of the companies involved in the transactions were based in India, therefore the liability to pay TDS to the income tax authorities of India did not arise. The ruling of the Supreme Court was thought to be the final word on this complex tax battle. However, soon after the Supreme Court decision, the government introduced a bill in parliament to amend the Income Tax Act. The amendment not only clarified that such offshore transactions are taxable, but it also applied it retroactively from 1 April 1962, the date on which the Indian Income Tax Act was enacted. The amendments were intended to achieve two goals: the first to overturn the Supreme Court's decision on Vodafone, and the second to force Vodafone to pay taxes. The amendments legalized the Supreme Court's decision to overturn Vodafone's tax demands.

Scope of S.9 Of the Income Tax Act, 1961

Section 9 of the Income Tax Act, 1961 deals with income deemed to accrue or arise in India. For the non-residents, income is taxable under the Income Tax Act, 1961 only if the income is accrued or arises in India. Therefore, section 9 was introduced in order to tax even those incomes of non-residents that may arise outside India so that the tax collection could be increased. S.9 says that irrespective of the fact whether income arise or accrued in India or outside India, it will be “deemed to accrue in India” if it falls under the given heads of section 9 and thus tax would be payable on such income. Section 9 (1)(i) of the Income Tax Act, 1961 provides that all income which is earned directly or indirectly, from any business connection

³ Niranjana, V., et al. “An Analysis of the Supreme Court’s Judgment in Vodafone - Part I.” IndiaCorpLaw, 9 Aug. 2017, indiacorplaw.in/2012/01/analysis-of-supreme-courts-judgment-in.html.

in India, or through or from any property in India, or through or from any asset or source of income in India or by the transfer of an asset located in India will be deemed to have been accrued or originated in India. The revenue contended that since the acquisition of share in CGP Investments gave rights to Vodafone to manage HEL, appoint its directors among many, therefore indirectly there was transfer of capital assets situated in India (HEL) and therefore s.9 was invoked and Vodafone was liable to pay tax on transfer of capital assets under s.9 of the Income Tax Act, 1961. Revenue argued that the transfer of shares between two foreign companies, resulting in extinguishment of controlling interest in the Indian Company held by a foreign company, amounted to transfer of capital assets in India and thus Vodafone was liable to pay Rs.22,1005 Cr tax to the Indian Tax authorities. On the other hand, Vodafone argued that since the transactions were involved between two foreign entities (Vodafone-Dutch & CGP-Cayman Island) there was no transfer of capital assets situate in India. It contended that the control they got over the Indian entity (HIL) was the interest flowing out of the transaction of purchase of shares of a foreign entity (CGP Investment) and therefore s.9 could not be invoked making the case out of the jurisdiction of the Income tax authorities of India.

Aftermath of the Judgement

Soon after the Supreme Court delivered its judgement against the revenue department, the Government amended s.9 of the Income Tax Act, 1961⁴. A new clause was added “For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or Incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share value substantially from the assets located in India”. The amendment was applied retrospectively. With the amendment, the onus to pay tax shifted on to the Vodafone company. In response to this, Vodafone commenced two investment arbitration cases against India at the Permanent Court of Arbitration (PCA). These cases were based on the alleged breach of fair and equitable treatment (FET) provisions outlined in the India-Netherlands Bilateral Investment Treaty (BIT) and DTAA. PCA ruled in favour of Vodafone and also imposed 40 Cr compensation on Indian Govt to be paid to Vodafone⁵. PCA ruled that retrospective amendment of s.9 was violation of “fair and equitable treatment” mentioned in DTAA between India and Netherland.

⁴ S.9, Income Tax Act, 1961.

⁵ “Taxmann.” <https://Mgst.Taxmann.Com, www.taxmann.com/research/direct-tax-laws/top-story/22233000000004732/decision-on-vodafone-tax-case-has-given-a-positive-signal-to-british-businesses>. Accessed 14 Nov. 2024.

Can of “Extinguishment of Rights” Be Seen Simultaneously With “Sale of Assets” Under S.2(47) Of Income Tax Act, 1961?

The Revenue department's primary argument in the Supreme Court was that a capital asset located in India existed, manifesting as various rights held by HTIL, which were "extinguished" under section 2(47) of the Income Tax Act, 1961, constituting a transfer upon the execution of the Sale Purchase Agreement (SPA) on 11.02.2007. For instance, HTIL, via its shareholding, held the authority to nominate directors, the privilege to use specific licenses, and the capacity to redeem particular shares. The Revenue attempted to reclassify the transaction from the sale of a wholly non-taxable entity (situated outside India) to the sale of its separate taxable components (located within India). The Supreme Court rejected this argument as well. The Chief Justice, in dismissing this argument, underscored that the court's attention was only on the sale of shares, rather than the sale of particular assets. The selling of shares should not be analyzed into separate components⁶. The Supreme Court made a significant observation, recognizing the potential for disagreement. It highlighted the intrinsic challenge for the Revenue to claim the automatic "extinguishment of rights" simultaneously with the sale of property.

The core of the Court's position is the acknowledgment that equating the termination of rights with the sale of property as concurrent occurrences presents difficulties and is not invariably clear-cut. The key argument provided by the Revenue department in the Supreme Court was that there was capital asset situate in India and this capital asset took the shape of multiple rights held by HTIL, which was "extinguished" under s.2(47) of the Income Tax Act, 1961 which amounted to Transfer upon the completion of the Sale Purchase Agreement (SPA) on February 11, 2007⁷. For example, HTIL, through its shareholding, owned the "right" to select directors, the right to utilize specified licenses, and the capacity to redeem certain shares. In other words, the Revenue tried to convert the transaction from the sale of a complete company not subject to taxation (located outside India) into the sale of its individual taxable components (located in India). The Supreme Court dismissed this argument as well. The Chief Justice, in

⁶ Pushpanjali. "Vodafone Case Analysis." TaxGuru, 6 Apr 2021, taxguru.in/income-tax/vodafone-case-analysis.html.

⁷ Standard, Business. "Vodafone Wins \$2 Bn Tax Case in Supreme Court." Business Standard, 20 Jan. 2012, www.business-standard.com/article/companies/vodafone-wins-2-bn-tax-case-in-supreme-court-112012000125_1.html.

rejecting this contention, noted that the court's focus was specifically on the sale of shares, not on the sale of particular assets.

It was stressed that a sale of shares should not be divided into distinct components. While conceding the potential for discussion, the Supreme Court made a significant comment. It pointed out the inherent difficulties for the Revenue to assert the automatic "extinguishment of rights" concurrently with the sale of property. The basis of the Court's opinion consists in the awareness that attributing the extinguishment of rights and the sale of property as contemporaneous events raises obstacles and is not always clear.

The Supreme Court concluded that the Revenue is restrained from resorting to the use of legal fictions when dealing with a plain "disposition of property in its ordinary and natural sense." In the context of the specific case under discussion, the transaction connected to the ordinary and natural disposition of an asset located outside India. The essential point here is that the Revenue is not entitled to utilize any legal structures or artificial scenarios to avoid or alter the fundamental nature of the transaction, especially where it involves the disposal of property in its ordinary and conventional manner. The claim is that, in such cases, the Revenue cannot utilize legal fictions to override the indisputable fact of the transaction being a standard and clear disposition of property placed beyond the jurisdiction of India.

Issue of Control Over Subsidiary Company by the Parent Company

In the context of DTAA interpretation, the problem of control over a subsidiary by a parent firm, as argued in the landmark Vodafone case, raises crucial considerations about tax jurisdiction and corporate independence. Under a DTAA, separate legal companies are often taxed independently; nevertheless, when a parent firm retains significant influence over a subsidiary's operations, designating them as wholly distinct taxpayers becomes problematic. The Supreme Court's opinion in the Vodafone case reinforces the idea that a subsidiary remains an autonomous legal character, despite overwhelming ownership and influence by a parent firm⁸. This notion becomes more essential when applying DTAA requirements, as the boundaries between ownership and control determine where and how income or gains should be taxed. For my project, which explores the "conundrum of interpreting DTAA in light of recent amendments in direct tax," this distinction is crucial. The question of 'control' and

⁸ The Vodafone Decision: All Is Not Lost - Nishith Desai, www.nishithdesai.com/fileadmin/user_upload/pdfs/The_Vodafone_Decision_-_All_Is_Not_Lost.pdf. Accessed 14 Nov. 2024.

‘independence’ under DTAA affects the structuring of multinational firms and the allocation of taxing rights, especially when revisions in domestic tax legislation and global treaty reforms add new layers to cross-border taxation interpretations.

The Supreme Court held that a corporation had an independent legal identity, and the ownership of all its shares by a single individual or the parent firm does not effect its distinct legal character. In the event of the subsidiary company liquidation, the liquidator, rather than the parent company, would assume control over the subsidiary company assets. None of the legal precedents indicate that the subsidiary firm assets are regarded those of the parent company, unless the subsidiary is working as an agent. Consequently, while a subsidiary may normally adhere to the orders of its parent firm, it is not just a puppet of the main company. Even if the parent company has the power to designate the directors of the subsidiary company, Directors of the subsidiary company are expected to discharge their duties to their individual companies (subsidiaries). They should not be subject to the control of the parent business unless it aligns with the interests of the subsidiaries. The influence imposed by the parent business as a shareholder on its subsidiaries does not decrease the decision-making autonomy or authority of the subsidiary's directors. They cannot be turned to mere puppets of the parent firm. The essential criteria is whether the management of the parent business⁹ exercises such influential control over the subsidiary's fundamental operations that the subsidiary can no longer be considered to perform those activities under the authority of its own executive directors.

However, the Supreme Court gave certain exceptions to the above scenario. Supreme Court held that it is acceptable to ignore or disregard the distinct legal status of the subsidiary company under certain circumstances, such as when the decision-making of the subsidiary company is deemed "fully subordinate" to the holding company or when the parent company engages in an "indirect transfer through abuse of legal form and without reasonable business purpose." The statement emphasizes that these examples are not exhaustive. Although the language of "fully subordinate" might initially suggest a willingness to pierce the corporate veil, this suggests that the Supreme Court allowed the tax authorities to ignore the separate legal identity of both the companies in cases where the business of the “subsidiary of the

⁹ “Rollback of Retro Tax: A Step in the Right Direction.” Lakshmikumaran & Sridharan: Top Law Firm in India, www.lakshmisri.com/insights/articles/rollback-of-retro-tax-a-step-in-the-right-direction/. Accessed 15 Nov. 2023.

subsidiary is the business of the parent company” and in such circumstances the tax can be imposed the actual controlling enterprise.

The Vodafone case serves as a landmark in comprehending the challenges of interpreting Double Taxation Avoidance Agreements (DTAAs), particularly in India. It highlighted important problems concerning treaty benefits, taxability of indirect transactions, and the breadth of domestic legislation vs treaty rules. The Supreme Court’s verdict, which initially supported Vodafone by stating that India could not tax the indirect transfer of assets, emphasized uncertainties in interpreting DTAAs governing cross-border transactions. Later revisions, including retrospective tax legislation, further muddled this issue, showing the continuous difficulty in aligning local tax objectives with international treaty commitments. This case remains significant because it shows the difficulties and interpretation issues that arise when national tax systems meet international treaty frameworks. In the context of evolving standards like BEPS and the Principal Purpose Test (PPT), the Vodafone case provides a foundational reference for discussions on how DTAAs should balance the prevention of tax abuse with legitimate business interests, making it central to contemporary DTAA interpretation challenges.

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Inclusion of Principal Purpose Test (PPT) in India-Mauritius DTAA: Possible Problems Which Can Emerge:

Action 6 of the BEPS¹⁰ initiative introduced the Principal Purpose Test (PPT) as one of the mandatory standards for participating countries in the BEPS Inclusive Framework. Countries were given a choice between two options: (i) adopting the PPT (either alone or in combination with a detailed or simplified Limitation on Benefits [LOB] provision) or (ii) implementing a detailed LOB alongside anti-conduit financing rules. According to the March 2019 peer review report on Action 6, countries are predominantly opting for option (i), with only the United States selecting option (ii)¹¹.

Thus, the PPT can be considered a key international tax standard for countries in the BEPS Inclusive Framework. However, implementing the PPT brings up questions regarding the uniformity of its application and the roles of various stakeholders—such as tax authorities, tax advisors, businesses, business associations, the judiciary, and academia—in interpreting this standard.

The influence of BEPS Actions on the global treaty network has been a central theme at various forums, including the 2020 Congress of the International Fiscal Association. Additionally, numerous conferences organized by tax advisors, academic institutions, business associations, and international and regional bodies have explored this topic. In this context, the following sections address some critical issues that may arise in implementing the PPT within the BEPS Inclusive Framework and the MLI, aiming to establish a minimum standard that supports global tax governance.

The Principal Purpose Test (PPT) is a key provision that prevents treaty abuse by disallowing tax benefits when the primary objective of a transaction or arrangement is to obtain such benefits. Under the PPT, if it can be shown that one of the main purposes of an arrangement was to gain favorable tax treatment under the treaty, the benefits will be denied. This provision aims to discourage strategies solely designed to exploit tax treaties for undue advantage, aligning with the broader goals of Base Erosion and Profit Shifting (BEPS).

In addition to introducing the PPT, the India-Mauritius have also updated the treaty's preamble to strengthen their stance against tax avoidance and evasion. Previously, the treaty's objective

¹⁰ BEPS, Action 6.

¹¹ Ibid.

was framed around promoting “mutual trade and investment” between the countries, emphasizing economic cooperation. However, this has now been modified to reflect a more targeted intent: to “eliminate double taxation” while explicitly preventing scenarios that enable non-taxation or reduced taxation resulting from tax evasion or avoidance schemes, including “treaty shopping” practices.

Treaty shopping, in particular, has been a long-standing issue in international tax. It involves structuring transactions through intermediary jurisdictions to take advantage of favorable tax treaties that would not otherwise apply. By revising the preamble, the countries signal their commitment to curbing such arrangements, emphasizing that the treaty is intended to prevent double taxation in a fair manner, not to create loopholes that can be exploited for aggressive tax planning.

This combination of the PPT and the revised preamble reflects a coordinated effort to close gaps that have historically been used to shift profits or avoid taxes by misusing treaties. By aligning the language of the treaty with the goals of transparency and fairness, the countries strengthen their ability to enforce the treaty in a way that is consistent with global tax standards.

Evolution of PPT in India: CBDT Circular and Azadi Bachao Case

Historically, treaty benefits—particularly the capital gains tax exemption under the India-Mauritius Double Taxation Avoidance Agreement (DTAA)—have been contentious, with frequent disputes centered on issues of beneficial ownership and the actual economic substance of transactions. The primary concern has been that entities lacking real economic activity or genuine business purposes could take advantage of the treaty merely by routing investments through Mauritius, thereby avoiding capital gains tax in India¹².

In response to these concerns, the Indian tax authorities issued a circular¹³ (CBDT circular 789 dated 13-04-2004) to clarify the criteria for determining beneficial ownership under the India-Mauritius DTAA. This circular provided guidance on how to establish residency and beneficial ownership for the purpose of claiming treaty benefits. Specifically, it stated that a Tax

¹² “Introduction of Principal Purpose Test in India - Mauritius Tax Treaty.” *Azb*, www.azbpartners.com/bank/introduction-of-principal-purpose-test-in-india-mauritius-tax. Accessed 19 Nov. 2024.

¹³ “Protocol to India-Mauritius DTAA Signed to Include Principal Purpose Test.” *EY US - Home*, www.ey.com/en_in/alerts-hub/2024/04/protocol-to-india-mauritius-dtaa-signed-to-include-principal-purpose-test. Accessed 19 Nov. 2024.

Residency Certificate (TRC) issued by the Mauritian tax authorities would serve as adequate proof of both residence and beneficial ownership under the DTAA¹⁴.

This clarification was intended to streamline the process, giving investors a clear standard to demonstrate treaty eligibility while aiming to prevent abuse of the tax exemption through shell companies or structures with minimal economic substance.

Original position of law: Union of India v. Azadi Bachao Andolan

In the *Union of India v. Azadi Bachao Andolan*¹⁵ case, a public interest litigation (PIL) was filed to challenge a government circular that affected the interpretation of residency under tax treaties. The key issue before the Supreme Court was whether a Tax Residency Certificate (TRC) provided by a foreign entity was sufficient proof of residency for tax purposes or whether tax authorities could re-evaluate this status despite the presence of a TRC.

The petitioner argued that merely holding a TRC should not prevent Indian tax authorities from probing further into the actual residency status of foreign entities, particularly to prevent treaty abuse. However, the Supreme Court ruled that a TRC issued by a foreign government should be considered conclusive evidence of residency. This ruling underscored that tax authorities in India should not re-assess or question residency beyond the TRC in cases covered by tax treaties, such as the India-Mauritius treaty.

The challenge against the government circular centred on the argument that a Tax Residency Certificate (TRC) should not be viewed as conclusive proof of residency under the treaty. Critics argued that treating the TRC as indisputable would open doors to treaty shopping and facilitate fraudulent practices that exploit tax treaty benefits without genuine economic substance. The Delhi High Court accepted this reasoning, finding that the circular effectively enabled treaty abuse, and it subsequently quashed the circular.

However, the Supreme Court overturned the Delhi High Court's judgment, emphasizing that treaty shopping, while potentially problematic, could also be beneficial for the long-term economic growth of the country by attracting foreign investment. The Court held that the circular merely clarified the intended scope and application of the India-Mauritius tax treaty, particularly regarding residency requirements. After this landmark decision, Indian courts

¹⁴ Ciat. "The Principal Purpose Test (PPT), the BEPS Inclusive Framework and MLI." *CIAT*, 4 July 1970, www.ciat.org/the-principal-purpose-test-ppt-the-beps-inclusive-framework-and-ml/?lang=en.

¹⁵ *Union of India v. Aazadi Bachao Andolan*, (2004) 10 SCC 1.

consistently regarded the TRC as conclusive proof of a taxpayer's residency under the treaty, barring further investigation into the residency status of entities holding a TRC.

Finance Bill 2012: A Significant Tax Amendment

The 2012 amendment in the Finance Bill marked a pivotal shift in India's approach to interpreting tax treaties, particularly in light of widespread concerns over treaty shopping and tax evasion. Previously, under the interpretation established in the Azadi Bachao Andolan case, a Tax Residency Certificate (TRC) was accepted as conclusive proof of residency, effectively limiting Indian tax authorities from questioning or investigating further if the TRC was validly issued by a foreign jurisdiction, such as Mauritius. This interpretation, however, led to criticism that foreign investors could easily exploit treaty benefits by establishing shell companies or entities with minimal or no actual business operations in the treaty partner countries, solely to benefit from favourable tax treatment in India.

With the Finance Bill 2012¹⁶, India signalled a tougher stance by explicitly empowering tax authorities to look beyond the TRC in evaluating claims for tax treaty benefits. The amendment clarified that while a TRC would still be required to claim treaty relief, it would not, on its own, prevent authorities from examining the economic substance and business presence of the entity claiming residency. By allowing for a deeper review, the amendment aimed to align treaty benefits with genuine economic activities, ensuring that only entities with actual, substantial ties to a treaty partner jurisdiction could qualify for reduced tax rates or exemptions. This change reflected a broader trend in global tax policy, particularly aligned with the OECD's recommendations against base erosion and profit shifting (BEPS)¹⁷, which encouraged nations to scrutinize and prevent treaty abuse by requiring proof of substantive economic engagement in the treaty partner country.

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¹⁶ Finance Bill, 2012.

¹⁷ Sekhar, - Metla Sudha, et al. "India, Mauritius Sign Protocol to Amend Tax Treaty; Principal Purpose Test Introduced." *The Economic Times*, economictimes.indiatimes.com/news/india/india-mauritius-sign-protocol-to-amend-tax-treaty-principal-purpose-test-introduced/articleshow/109224235.cms?from=mdr. Accessed 19 Nov. 2024.

Recent Contrary Rulings by the Courts:

- **Blackstone Judgement**

In a recent landmark ruling in *Blackstone Capital Partners (Singapore) VI FDI Three Pte Ltd v. ACIT*¹⁸, the Delhi High Court upheld the principle that Indian tax authorities cannot disregard a valid Tax Residency Certificate (TRC) when deciding the eligibility for capital gains tax exemption under Article 13(4A) of the India-Singapore Double Taxation Avoidance Agreement (DTAA). This judgment arose in circumstances where Blackstone, the taxpayer, met all conditions laid out in the DTAA's Limitation of Benefit (LoB) clause, and this compliance was never previously disputed by tax authorities.

The High Court emphasized that the concept of “beneficial ownership” should not be an additional test for determining entitlement to treaty benefits unless it is expressly mandated by the DTAA. Therefore, any requirement for beneficial ownership to qualify for tax exemptions, such as the capital gains exemption in this case, must be clearly specified in the treaty itself. In other words, if the DTAA does not explicitly include beneficial ownership as a prerequisite, then the authorities should not read it into the treaty terms.

Under India's domestic tax regulations, a non-resident is generally required to produce a TRC issued by the competent authority in their country of residence to avail themselves of DTAA benefits. In the Blackstone case, the Indian tax authorities attempted to deny the capital gains tax exemption claimed by Blackstone's Singaporean subsidiary, which had sold “grandfathered shares” (shares acquired before April 1, 2017, when the DTAA terms were amended). Despite the Singaporean tax authority's issuance of a TRC, the Indian authorities argued that Blackstone Singapore was not the “beneficial owner” of the income from these capital gains.

However, the High Court, drawing on prior tax department circulars and precedents, ruled decisively in favour of Blackstone. The court determined that possessing a valid TRC is sufficient to establish the taxpayer's residential status, eligibility for DTAA benefits, and legal ownership of the income in question. It rejected the attempt by the tax authorities to impose an additional beneficial ownership criterion (Principal Purpose Test) that was not explicitly stated in the DTAA for the capital gains tax exemption.

Furthermore, the decision underscores the importance of honouring the negotiated terms of international tax treaties. The court held that treaties are binding agreements and that the terms

¹⁸ ACIT v. Blackstone Capital Partners (Singapore) VI FDI Three (P.) Ltd. - [2024] 158 taxmann.com 261 (SC).

agreed upon by the two countries must be respected in their entirety. Unilateral reinterpretation or disregard of the agreed terms by one country, as seen in this case, undermines the stability and predictability that tax treaties are intended to provide for cross-border transactions and investments.

This ruling sets a precedent by affirming that unless a treaty explicitly includes beneficial ownership as a requirement for availing tax benefits, authorities are not entitled to impose it. This enhances the certainty with which foreign investors can rely on DTAA provisions, ultimately supporting a stable and predictable tax regime for international business.

- **Tiger Global Int. Holding Judgement**

In another notable ruling, the Delhi High Court in *Tiger Global International Holdings v. The Authority for Advance Rulings (Income-Tax) & Others*¹⁹ emphasized the critical role of the Tax Residency Certificate (TRC) in international tax matters. This case, which attracted the attention of global corporations and tax experts, focused on whether the TRC alone is sufficient to claim tax treaty benefits under double taxation avoidance agreements (DTAAs). By ruling in favour of the TRC's legitimacy as definitive evidence of tax residency, the court has provided a crucial affirmation for foreign investors and multinational companies navigating India's tax system.

The decision upholds the principle that a valid TRC, issued by the relevant authority in a taxpayer's country of residence, should ordinarily be enough to establish treaty eligibility without needing additional proof of residency or ownership. This validation of the TRC as an essential document strengthens India's commitment to honouring its treaty obligations, ensuring that international treaties are respected and that foreign investors can have a predictable and reliable framework within which to operate. The court's stance effectively minimizes the risk of disputes and administrative obstacles for businesses that would otherwise face scrutiny over their residency status despite holding a valid TRC.

The impact of this judgment is likely to be broad, as it not only reinforces legal certainty in cross-border tax matters but also signals India's support for an investor-friendly tax environment. Multinational corporations, assured of their eligibility for DTAA benefits upon presenting a TRC, can now approach investments in India with greater confidence, knowing

¹⁹ *Tiger Global III Holdings v Authority for Advance Rulings*, 2024 SCC OnLine Del 5987.

they are less likely to face bureaucratic roadblocks or prolonged litigation over tax residency issues.

In reaffirming the TRC's validity as an accepted standard for determining eligibility under tax treaties, the judgment underscores the broader significance of DTAA's in fostering international trade and investment. This clarity on TRC reliance encourages cross-border transactions²⁰ by offering foreign investors reassurance that India's tax policies will respect established treaty arrangements, ultimately making India a more attractive destination for global capital. By upholding the TRC's role, the Delhi High Court has set a precedent that could influence similar cases, reducing uncertainties and enhancing India's reputation in the international investment community.

Buyback Tax Reform: Potential Problems in DTAA's.

A share buyback is a financial strategy in which a firm reacquires its own shares from shareholders, therefore decreasing the total number of outstanding shares. This action can augment the value of the residual shares and improve the company's financial metrics. The company's buyback shares are utilized to optimize its capital structure and, in the current business landscape, provide a vital exit strategy for investors.

Under the Companies Act, 2013, buybacks must be funded from (i) free reserves, (ii) the issuing of new shares (distinct from those repurchased), or (iii) the company's securities premium account.

As per the Finance Act (No. 2) 2023 from October 1, 2024, new restrictions on tax for buybacks of shares will be adopted, transferring the income tax burden from companies to shareholders. These developments will now influence companies' capital allocation patterns and their investment strategies.

Changes in the definition of Buyback:

The Finance Act 2023 made a fundamental change to the taxes landscape in India by extending the term of "buyback"²¹. Previously, buybacks were widely considered as direct repurchases by firms of their own shares from shareholders. This limited approach was consistent across multiple legal and treaty contexts, which helped establish obvious tax implications, notably

²⁰ Singal, Eshaan. "Home " *Tax Treaty Tussle Tiger Global s Grandfathering Saga*, www.taxmanagementindia.com/visitor/detail_article.asp?ArticleID=12990. Accessed 19 Nov. 2024.

²¹ S.22 (2), Income Tax Act, 1961.

under DTAA's. However, the Finance Act's broadened meaning now includes a larger range of transactions under buybacks, potentially causing issues for interpreting its scope under the current DTAA's. This adjustment affects multinational corporations and foreign investors who rely on DTAA's for protection against double taxation, as the revised scope of buybacks may influence how these transactions are regarded for tax purposes.

Implications under the Double Taxation Avoidance Agreements (DTAAs)

The broader concept of repurchase poses problems for applying DTAA requirements, as many DTAA's were established under the assumption of a limited, traditional interpretation of buybacks. DTAA's normally assign taxing rights for capital gains and dividends, but buybacks have traditionally had distinct status. For example, under many treaties, capital gains from the sale of shares by foreign shareholders are only taxable in the country of residence, whereas dividends may be taxed both in the source country (where the income originates) and the residence country.

Ambiguity in Classifying Income: Dividend or Capital Gains?

With the extended repurchase definition, the nature of income earned from buyback transactions can become uncertain under DTAA's. Under the former definition, revenue from a repurchase was often classified as capital gains, (Article 13 on capital gains in India-Mauritius DTAA²²) allowing foreign investors to benefit from DTAA rules that often insulate capital gains from taxation in India. However, the new, broader definition²³ may blur the boundary between capital gains and dividends, as many transactions labeled as buybacks can resemble dividend distributions, especially where the corporation is returning earnings to shareholders indirectly. If these extended buybacks are construed as dividends by Indian tax authorities, foreign owners may face a larger tax penalty, as most treaties allow India to tax dividends at a higher rate than capital gains. This reclassification can undermine the treaty benefits that investors previously depended on.

Conflicting Interpretations between India and Treaty Partners

The broadened buyback definition may potentially result in interpretation issues between India and its treaty partners. Different countries may have varying definitions or interpretations of what constitutes a repurchase, particularly if they rely on a limited understanding

²² Article 13, India-Mauritius DTAA.

²³ Ibid.

comparable to India's earlier structure. For instance, if India reclassifies a transaction as a buyback under its broader definition and sees it as dividend income, but the treaty partner (Mauritius) considers it a capital gain, there may be no clear conclusion under the DTAA. This could result in double taxation, since both countries assert taxing rights based on conflicting interpretations of the same transaction. Consequently, corporations and investors may have difficulty in getting tax credits or relief for taxes paid, thereby defeating the fundamental objective of DTAA²⁴s.

Impact on Foreign Investor's and Cross-Border Transactions²⁵

The broader repurchase definition may have far-reaching repercussions for foreign investment. With increased uncertainty over tax consequences, overseas investors may become sceptical about capital transactions involving Indian firms. The ambiguity surrounding the classification of revenue from buybacks may lead to investors facing unanticipated tax consequences, lowering the attractiveness of the Indian market for cross-border mergers, acquisitions, and capital restructurings. Furthermore, this shift could inhibit capital flows into India if international corporations regard the tax landscape as unpredictable, especially if they are unable to rely on the certainty formerly offered by DTAAs. The uncertainty generated by the revised repurchase could effect strategic business decisions, as corporations may reassess or restructure acquisitions to limit exposure to India's widened buyback tax implications. This could also influence how international firms choose to finance their Indian operations, as the dangers of unexpected repurchase classification could complicate cross-border capital injections, dividend policy, and other financial strategies.

This move poses interpretation challenges under existing DTAAs, which were generally established with a more restricted knowledge of buybacks. For foreign investors, this presents the possibility of treaty benefits being lost, as income formerly regarded as capital gains may now be construed as dividend income. The potential for divergent interpretations, coupled with heightened scrutiny, could lead to more administrative hassles and disputes, ultimately harming foreign investment. As a result, international corporations may need to rethink their plans,

²⁴ Bharat Vasani, Miloni Mau. "Buy-Back of Shares: Will Recent Changes in the Tax Laws End the Party?" *India Corporate Law*, 19 Aug. 2024, corporate.cyrilamarchandblogs.com/2024/08/buy-back-of-shares-will-recent-changes-in-the-tax-laws-end-the-party/.

²⁵ "Redefining Buy-Back: Tax Implications under Finance Act (No. 2), 2024." *S&R Associates*, 23 Aug. 2024, www.snrlaw.in/redefining-buy-back-tax-implications-under-finance-act-no-2-2024/.

anticipate prospective tax liabilities, and seek legal clarity on how these changes would be applied.

Conclusion

The difficulty in interpreting Double Taxation Avoidance Agreements (DTAAs) is an important challenge in international tax law, especially in light of landmark cases, anti-abuse measures, and shifting domestic tax definitions. Through an examination of key topics, including the Vodafone case, the Principal Purpose Test (PPT), and recent changes in the definition of buyback, it becomes clear that complexities in treaty interpretation are shaped by competing interests between preventing tax avoidance and providing certainty for cross-border investments.

The Vodafone case demonstrated the limitations of India's domestic laws when applied retroactively to tax cross-border transactions, underscoring the necessity for unambiguous DTAA provisions that preclude unilateral reinterpretations. This case underlined the necessity of adhering to treaty commitments, as retroactive taxes can weaken investor trust and strain international ties.

The adoption of the Principal Purpose Test (PPT) as an anti-abuse clause in treaties adds another degree of complexity, shifting the attention to substance above form. By permitting tax authorities to refuse benefits if the major goal of a transaction is perceived to be tax avoidance, the PPT raises an interpretation issue. The approach, however, risks subjective implementation, necessitating a careful balance between enforcing anti-abuse measures and maintaining treaty certainty to guarantee that actual economic activities are not adversely damaged.

Finally, the recent modifications in the definition of buyback in the Finance Act indicate how domestic law changes might affect DTAA interpretation. By widening the definition of what constitutes a buyback, India risks developing different interpretations with treaty partners, especially if DTAAs were initially written with a limited understanding. This adjustment may result in uncertainty for international investors, who may face new tax implications or challenges in identifying whether income from buybacks is classed as capital gains or dividend income under treaties.

We can conclude that the developing environment of DTAA interpretation reflects a broader global movement toward boosting tax compliance while protecting equitable treaty advantages. However, balancing these aims needs international cooperation, transparency, and

harmonization of standards. Addressing interpretive conundrums in DTAA's is vital to establishing a stable investment environment and supporting sustainable cross-border economic activity.

