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CAPITAL GAINS TAX AVOIDANCE IN DIGITAL ERA: POSITION OF INDIAN TAX TREATIES POST BEPS ACTION PLAN WITH SPECIAL REFERENCE TO *SANOFI'S* CASE

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INTRODUCTION

The taxation of capital gains holds significant importance within the realm of international tax treaties, as it pertains to the distribution of taxing authority among participating nations about the profits generated from the transfer or transfer of assets. This article explores the regulation of capital gains taxation in Double Taxation Avoidance Agreements (DTAAs) between India and other countries, with a specific focus on two different models used in these agreements.

The initial model, as demonstrated by the India-France Double Taxation Avoidance Agreement (DTAA), adopts a strategy that prioritizes the resident state. The taxing rights for capital gains are distributed in a fragmented way, with distinct allocations for different categories of assets. This model confers onto both contractual parties the power to impose capital gains on the transfer of immovable property and the transfer of moveable property that is integral to a permanent establishment. Furthermore, it confers the exclusive authority to tax capital gains derived from the transfer of ships or planes to the jurisdiction in which the individual resides.
Moreover, this particular model enables both contracting nations to impose taxation on capital gains derived from the transfer of business shares that are comprised of real estate assets, whether directly or indirectly. Significantly, it also grants both contracting parties the authority to tax capital gains that result from the transfer of shares reflecting a stake of ten percent or more in a corporation in the source state. It is noteworthy that any further form of capital gains that falls outside the scope of these particular allocations is allocated to the resident state, so demonstrating a distinct inclination towards the notion of residence-based taxes.
A distinct method is employed by the second model, which is observed in tax treaties with nations such as the United States and the United Kingdom. Neither of the contracting parties is prohibited from taxing capital gains. However, it delegates the responsibility to the domestic tax systems of the two parties involved in the contract, which may result in the occurrence of double taxation. Under such circumstances, taxpayers are compelled to depend on tax credits in order to alleviate the ensuing tax liability.

The terminology included in these Double Taxation Avoidance Agreements (DTAAs), such as "alienation" and "participation," may not consistently correspond to the concepts outlined in domestic tax laws, which could lead to conflicts and uncertainties in their interpretation. This article delves into capital Gains tax planning aspects in countries with different taxing models. It also highlights the problems associated with indirect transfer with special reference to *Sanofi's* case, which was one of the first of its kind. It also analyses the capital gains taxation post BEPS and GAAR.

How do the different models employed in Double Taxation Avoidance Agreements between India and other countries allocate the taxing rights over capital gains, and what are the implications of these models for taxpayers,

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tax authorities, and the interpretation of tax treaties in light of domestic tax laws?

CAPITAL GAINS UNDER INDIAN ACT

The deeming provision that gave birth to Indian tax law on capital gains is still in use today, complicating the law's application. There is no longer any doubt that income can emerge from the sale of an asset because Section 2(24)(vi)[959] of the ITA incorporates capital gains within the definition of income. A transfer of a capital asset results in the imposition of income tax on any resulting capital gains, according to provision 45, the charging provision, which lays out the foundations of India's capital gains taxation. Section 2 of the ITA defines "transfer" and "capital asset" as well.

The ITA's definition of "transfer" includes the sale, renunciation, exchange, and extinguishment of rights in an asset, just like the India Mauritius DTAA's concept of "alienation." Property of any kind is referred to as a capital asset. After the Supreme Court's ruling in Vodafone, each of these definitions in the ITA received substantial amendments. The Vodafone case, the most notorious judgment in Indian case law, was soon eclipsed in its notoriety by the legislative amendments enacted to counter the judgment. The terms of "transfer," "property," and "nexus" came into conflict in Vodafone, creating a tax planning opportunity. We have already covered the terms "transfer" and "property." Nexus was a term used to describe how a country's tax laws applied over its entire territory. Under Section 5 r/w Section 9 of the ITA, capital gains arising only out of the transfer of assets situated in India is considered as subject to taxation under the ITA.

The Vodafone controversy started with a tax planning strategy that benefited from how the terms "transfer," "property," and "nexus" were translated into statutory provisions in the ITA. For the sake of the discussion in this part, the Vodafone facts can be condensed to the following outline. Shares in a non-resident firm were up for sale, and the buyer was another non-resident corporation. None of the three parties—the buyer, the seller, and the asset that was the subject of the transfer—had a connection to India, except for one factor. The company held shares in an Indian company that had substantial assets in India. The shares were being transferred. Only because of the value in the underlying Indian assets were the buyer and seller in negotiations, and the main commercial concern throughout was how to transfer control of the underlying Indian assets in the most tax-efficient way.

The sellers, advised by their tax lawyers, took advantage of the nexus provisions in the ITA, discussed above, by transferring the shares of a foreign company that had Indian subsidiaries (with Indian assets). When the Revenue objected, the sellers claimed that the "nexus" restrictions in Section 9 were only intended to apply to direct transfers of shares of Indian companies, not to indirect transactions of the Vodafone kind. The government added an explanation to Section 9 (with retrospective effect) to clarify that both direct and indirect transfer of shares of Indian companies would be subject to the nexus rules in Section 9. The Supreme Court sided with the sellers, and what transpired has since become a slice of sensational tax history.

The amendment to the nexus rules alone did not satisfy the government, though. Additionally, it amended Section 2 such that both "transfer" and "property" had a new conceptual foundation retrospectively. It was clarified that management or control rights over an Indian firm, whether held directly or indirectly, are now included in the definition of "property" in Section 2(14). The definition of 'transfer' in Section 2(47)[960] was amended (by way of an explanation) to include situations where such management or control rights were acquired indirectly or acquired as a result of the transfer of an upstream foreign company. Thus, if a person transferred the shares of a foreign

[959] Income Tax Act, 1961, § 2(24)(vi), No. 43, Acts of Parliament, 1961

[960] [960] Income Tax Act, 1961, § 2(47), No. 43, Acts of Parliament, 1961

company that in turn, held the shares of an Indian company, there was a possible transfer of control rights over the Indian company. The word possible is used to qualify the idea of transfer here because there is no further direction in Section 2 on what constitutes control. Presumably, the transfer of the shares of a foreign subsidiary that in turn has an Indian subsidiary would be covered under these provisions.

As a result, if the non-resident sold the shares in his foreign company in a Vodafone-like scenario, it would be deemed that he had simultaneously transferred two different types of property: the shares in his foreign company as well as the control over the Indian company that he acquired as a result of his shareholding in the foreign the company. The ITA has once again included a logical conundrum into one of its statutory provisions. Now, the same transaction can produce two distinct types of transfers, each of which could result in a capital gain. The most glaring problem is the application of the capital gains computational provisions to the transfer of the asset identified as control over an Indian company.

The case law on computational provisions related to capital gains, presented by the famous *Srinivas Setty* case, gives equal prominence to computational and substantive provisions in capital gains taxation, to the extent that if the computational provisions fail, the failure will take down the substantive provisions with it. If the ITA fails to provide a workable formula to calculate the cost or the selling price of the asset that is being transferred, no capital gains tax can attach to such a transfer. There are no guidelines either under the ITA or the regulations that specify the manner in which the cost of the control over the Indian company will have to be calculated.

The 'nexus' provisions in Section 9 underwent another set of parallel amendments that fortunately prevented the issues mentioned above for the Revenue. In Section 9, it was explained that shares of a foreign company would be regarded as situated in India if they received a significant portion of their value from Indian assets. The justification was intriguing because, for the first time, the tax law established a link between underlying assets and shares of a foreign company (for example, Assets situated in India held by a subsidiary of the foreign company). When would it be deemed that a foreign company's shares derive their value from assets situated in India? Section 9 now includes an additional explanation to clarify the concept of derivation. The shares of the foreign company would be considered to derive a substantial portion of their value from assets located in India if the value of the assets situated in India made up at least 50% of the total value of all the assets owned by the foreign company.

The result of modifying the nexus criteria to include foreign corporations with Indian subsidiaries was that revenue did not have to worry about the above-mentioned costing concerns when talking about the revised definitions of "transfer and property." The shares of a foreign company would be regarded as being situated in India and the transfer of such shares would be seen as emerging in India as long as the fifty percent Indian asset threshold was crossed. The cost and sales consideration computations for the shares of the foreign company will proceed normally once an Indian tax nexus over such a transfer is established.

THE PROBLEM ASSOCIATED INDIRECT TRANSFERS AND TAX TREATIES: M/S. *SANOFI* PASTEUR HOLDING SA V. DEPARTMENT OF REVENUE[961]

Sanofi was the first major indirect transfer case that had two interlocking components that added to its complexity: the case involved an indirect sale of the shares of an Indian company, and the potential capital gains on the sale was being sought to be protected under a DTAA. The sellers were two French companies, MA and GIMD, and the buyer was another

[961] M/S. *SANOFI* PASTEUR HOLDING SA V. DEPARTMENT OF REVENUE, [2013] 354 ITR 316 (AP)

French company, *Sanofi.* The subject matter of the sale was ShanH, a French company. The only Indian connection was that ShanH held the shares of SBL, an Indian bio-technology company, which was the reason for the buyer's interest in buying ShanH shares.

The Revenue argued first for complete erasure of the reality of ShanH, which, if agreed to by the court, would have the effect of the sale of ShanH shares being recharacterized as a sale of SBL shares from MA/GIMD to *Sanofi.* The Revenue argued that ShanH did not have any substance, that consequently this was an alienation of Indian company shares representing more than a ten percent participation in the share capital of an Indian company, and as a result, India had the right to tax the capital gains under Article 14(5) of the DTAA. Why did the Revenue adopt an approach that ignored the legal reality of an incorporated company? The Revenue probably believed that without ignoring the legal reality of ShanH Article 14(5) could not be applied. A threshold requirement for Article 14(5) to apply was that shares representing a participation of at least ten percent in an Indian company had to be alienated.

The Revenue argued on the basis that there were two independent requirements for Article 14(5) to apply. One, there must be shares that represent ten percent of participation in an Indian company. Second, such shares (that represent the required participation) must be alienated. The Revenue tried to fulfill the first requirement by lifting the corporate veil provided by ShanH. Once the corporate veil was lifted, the requirement of alienation can be fulfilled using the definition of 'transfer' in the ITA to include indirect transfers of Indian company's shares. The Revenue's argument was that since 'alienation' was not defined in the DTAA, the only recourse is the domestic legislation.[962] The ITA, by virtue of the retrospective amendment to the definition of 'transfer', includes indirect transfers of Indian company's shares.[963]

The Revenue's decision to insist on ignoring the legal reality of ShanH meant it had a very high mountain to climb, particularly, after the decisions like *Vodafone,* which had refused to ignore the legal reality of incorporated companies. The Revenue made piercing of the corporate veil, the centerpiece of their legal strategy, which is a bit surprising since the Revenue's hands had been strengthened after the 2012 amendments. The amendments to the definition provisions in the ITA changed not only the definition of 'transfer' but also that of property. For the first time, a right of control or management over a company was considered as the kind of property that is subject to the capital gains regime. Traditionally, these rights were considered as merely contractual rights (arising from the MOA, and therefore, rights in *personem* instead of rights in rem. There is precedent in Indian case law that confines capital assets to rights in *rem.*[964] The explanations added to the definition of a capital asset in Section 2 signified a different approach to the domestic tar laws understanding of 'property. The expansion of the definition of 'property' into control or management rights in effect sidesteps the problem with regard to lifting of the corporate veil. If one company A owns all the shares of company B and company B owns all the shares of company C, the explanation of 'property' in Section 2 of the ITA[965] enables the Revenue to argue that company A has property (control or management rights in company C) without getting into the legal morass of piercing the corporate veil. It remained to be seen if the amended definition of 'property' can apply in a DTAA situation where the treaty was entered into before the amendments were affected. This issue is addressed below.

Since the Revenue chose to go through the route of piercing the corporate veil, they made a forensic examination of the sale transaction between MA, GIMD and *Sanofi.* They argued that ShanH was not a party to any confidentiality

[962] As per Article 3(2) of the India France DTAA.
[963] *Sanofi, p 18.*
[964] *Sharp Business System v. CIT-III [2012] 211 Taxman 576 (Delhi High Court)*
[965] [965] Income Tax Act, 1961, § 2, No. 43, Acts of Parliament, 1961

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agreement even though it was ShanH shares that were being transferred, that the entire sale was conditioned on SBL, the underlying Indian entity, fulfilling certain economic parameters, and that ShanH had no employees and it had no material assets other than the shares of SBL.[966] In response to the Revenue's arguments, the taxpayers argued that a special purpose vehicle (SPVs) such as ShanH is common in the corporate world and has been used by the MA group to invest out of France into other jurisdictions and that SPVs enable a business to isolate commercial risks and attract investments.

The court agreed with the taxpayers that ShanH, which even the Revenue conceded was not birthed as a tax avoidance device, could not become a non-entity for tax purposes only because it was used as an investment vehicle for India. As expected, the court relied on *Vodafone* to state the principle that a corporate entity will not be disregarded unless there was a 'wholesale subordination of the subsidiary's decision-making to the parent company'. The court also noted that the confidentiality agreement was meant to safeguard vital information provided to *Sanofi* and did not have any bearing on the legal reality of ShanH. The court concluded that there was no case made out to ignore ShanH as a corporate entity. As stated before, piercing the corporate veil is a rare occurrence in tax law.

The court also addressed the Revenue's argument that the post amendment definition of 'transfer would apply to the DTAA. The court's approach is important here because its decision on this point would apply to the amendment of the definition of 'property' as well. The court first considered the taxpayer's argument that when the amendments will not override the DTAAs.[967] The role of speech made by the mover of the bill while introducing the bill has been a matter of great debate ever since *Pepper v. Hart.*[968] The court quoted the Supreme Court in *KP Verghese v. ITO, Ernakulam and another*[969] to make the point that relying on the mover of the bill is legitimate because it 'is in accord with the recent trend in juristic thought not only in western countries but also in India that interpretation of a statute being an exercise in the ascertainment of meaning, everything which is logically relevant should be admissible.'[970] It appears that the court was willing to take into account the views of the Finance Minister in introducing the 2012 amendments.

Even apart from relying on the Finance Minister's remarks, the court was not inclined to let the 2012 retrospective amendments affect the operation of the India France DTAA. It relied on two other legal bases for denying the application of the retrospective amendments. First, there was existing case law on the point in other jurisdictions. In the case of *R v. Milford,*[971] the Canadian Supreme Court held that domestic amendments could not impact the interpretation of DTAAs even if the terms of the DTAAs rely on domestic law definitions because otherwise, the domestic legislature would have the power to amend DTAAs unilaterally. The court recognized one exception: if the domestic legislation expressly made the domestic law override the DTAAs. This exception pointed out by the Canadian Supreme Court brought the Andhra Pradesh High Court to its next point: unlike the GAAR provisions, the retrospective amendments in 2012 to the definitions of 'transfer' (and 'property') do not have a non-obstante clause and therefore will not override the understanding of the DTAA that prevailed when the DTAA was signed.[972]

The court did not comment on the form in which the 2012 amendments were enacted. The amendments were couched as explanations to the existing law that were deemed to be in

[966] *Sanofi, p 45 (no material assets or employees), 58 (confidentiality agreement), 59 (SBL fulfilling economic parameters)*

[967] *The Finance Minister likely meant that the pre-amendment understanding of the DTAAs will not be impacted by the amendments. Otherwise, when the DTAAs refer to domestic tax law in their provisions, the current state of the domestic tax law will apply, and there will be no incompatibility between the DTAAs and the domestic tax legislation.*

[968] *Pepper v. Hart [1992] UKHL 3*

[969] *KP Verghese v. ITO, Ernakulam and another (1981) 4 SCC 173*

[970] *Sanofi, p 74*

[971] *R v. Milford (1982) 2 SCR 504*

[972] *Sanofi, p 77*

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effect from the inception of the income tax legislation. This is an extraordinary way of amending legislation. The explanations to the definitions of transfer and 'property were not mere statements of the existing law but were introduced to change radically the notions that they purported to explain. Not many lawyers who dealt with the ITA before 2012 thought that 'property' would include control and management rights of a company or that transfers would include indirect transfers or that one could look through shareholding to determine the idea of a company's shares. Indian courts have held before that they would not be satisfied with the government's characterization of the amendments, and therefore, the fact that retrospective amendments were couched as explanations is unlikely to receive judicial approval in India although, in *Sanafi*, the court did not really comment on the retrospective nature of the amendments.

The court also stated that in any case it was not permissible to understand alienation in terms of transfers since the two terms are not identical. Article 3(2) of the India-France DTAA states that any term not defined in the DTAA has the meaning that it has under the respective domestic laws of the contracting parties. However in this case, Indian domestic law does not use alienation as one of the elements of capital gains, and hence, the meaning of 'transfer (whether retrospectively understood or otherwise) cannot be used to understand the meaning of alienation'. The court used the example of the India-Mauritius DTAA, which uses the idea of transfer to explain the meaning of 'alienation' and thus potentially opens up possibilities for the domestic meaning of transfer to impact the understanding of alienation.[973]

One argument that was available with the Revenue was to argue that the word 'alienation' in Article 14(5) is, just by virtue of the word, capable of including indirect transfers. The Revenue did, in fact, put forth the case of *Commissioner for the South African Revenue Services v. Tradehold Ltd*,[974] decided by the South African Court of Appeal. This case was concerned with the DTAA between South Africa (SA) and Luxembourg, which had provisions similar to Article 14(5) and Article 14(6) of the India-France DTAA. A South African company changed its residence to Luxembourg, and under the South African (SA) tax law, deemed to have incurred a capital gain. The company argued that the deemed sale would be covered by the equivalent of Article 14(6) because alienations included deemed sales, and therefore, Luxembourg would tax it. The SA Court of Appeal agreed with the company and stated that 'alienation' was a term chat was wide enough to include deemed sales.

The AP High Court opined that *Tradehold* was not applicable to the *Sanofi* facts because on a true, fair and good faith interpretation, no provision of Article 14 of [the India-France] D'TAA accommodates dual taxation, i.e., by both the Contracting States.[975] The court declined to entertain an interpretation under which, with respect to the same transaction, there would be deemed sale subject to tax in India, and there would be an actual sale subject to tax in France. This part of the AP High Court's decision is difficult to square with the India-France DTAA considering the fact that Article l4 does envisage double taxation of capital gains, when it comes to sale of immovable property. In any case, as the court pointed out, even under the Revenue argument, the capital assets being discussed are the control and management rights over SBL (not participation interest), and such rights come under the residual clause in Article 14(6), and are, therefore, allotted to France.[976] However, the Revenue, while using Tradehold, was arguing not on the disposal of control rights but on the deemed disposal of SBL shares. However, *Sanofi* is different from *Tradehold* in one respect in that the deemed

[973] *Sanofi*, p 88

[974] *Commissioner for the South African Revenue Services v. Tradehold Ltd (2010) ZASAC 61.*

[975] *Sanofi*, p 83.

[976] *Sanofi, p 83.*

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disposal in *Tradehold* will not result in complications relating to the calculation of capital gains whereas, in *Sanofi*, a deemed disposal means that one has to calculate capital gains for a transaction in which the alleged shareholders don't actually own the shares, thus resulting in some ambiguity about how to determine the consideration and the cost basis of the transaction. The Revenue argued that the consideration would be the cash value of the sale of ShanH shares and the cost would be the cost at which ShanH acquired SBL shares.[977] The court rejected the approach of the Revenue and said that when it came to the transfer of rights of control, the consideration and cost were not capable of being calculated.[978] The courts' approach means that the government's plan to expand the concept of 'property' will be futile if there are no further statutory guidelines on how to calculate the associated capital gains.

Finally, the court took note of a Canadian case, which was relatively insignificant for purposes of the *Sanofi* decision, but is an important case in the post BEPS world.[979] In this case, the taxpayer had chosen the Canada-Luxembourg DTAA with a view to taking advantage of the DTAA benefits. The Canadian Revenue challenged the taxpayer's transaction on the basis that the DTAA benefits should be denied because the treaty jurisdiction was chosen deliberately to avoid taxation. The Revenue appeared to be arguing that the DTAA ought to be constructed with an anti-avoidance interpretive approach in mind. The court denied the Revenue's appeal because there was no express anti-tax avoidance provision in the Canada-Luxembourg DTAA. This is an essential point because today, in the post BEPS world, we have a specific anti-avoidance rule envisaged for virtually all tax treaties.

[977] *Sanofi, p 92.*
[978] *Sanofi, p 92.*
[979] *MIL (Investment) SA v. Canada 9 ITLR 25.*

CAPITAL GAINS UNDER DTAAs: THE POST BEPS AND THE POST GAAR SCENARIO

The *Sanofi* judgment was delivered in 2013, after which there were two significant developments relating to international tax law in India. First, in 2017, India amended the ITA to include General Anti Avoidance Rules (GAAR). The GAAR provisions target abusive transactions that escape the tax net because they do not unless legislation is expansively interpreted, come within the grasp of any legislative rule. The Indian Supreme Court, in cases like *Azadi Bachao Andolan*[980] and *Vodafone,*[981] had refused the kind of open-ended interpretation of statutes endorsed by Justice Chinnappa Reddy in *McDowell.*[982] The government, to counter this problem, introduced the GAAR, which in one sense can be seen as giving statutory life to Justice Chinappa Reddy' excoriation of colourable transactions.

The GAAR identifies an abusive tax avoidance as an impermissible tax avoidance arrangement that has two characteristics.[983] First, it must be an arrangement the main purpose of which is to obtain a tax benefit, and in addition, such an arrangement has at least one of the following four abusive features:

1. It creates rights or obligations, which are not ordinarily created between persons dealing at arm's length;
2. results, directly or indirectly, in the misuse or abuse of the provisions of the ITA;
3. lacks commercial substance or is deemed to lack commercial substance;
4. is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

The GAAR has two features that are especially novel and therefore troubling for interpreters of tax law. First, phrases with broad connotations are used, as is seen in the wording referring to

[980] *Union of India v. Azadi Bachao Andolan [2003] 132 Taxman 373 (SC).*
[981] *Vodafone International Holdings B.V. v. Union of India and Anr [2012] 1 SCR 573*
[982] *McDowell & Co. Ltd. v. CTO, [1985] 3 SCR 791. See Justice Reddy's comments at McDowell & Co. Ltd. v. CTO, [1985] 3 SCR 791, 809.*
[983] Income Tax Act, 1961, § 96, No. 43, Acts of Parliament, 1961

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the misuse or abuse of ITA rules. This is a difficulty with how the law should be interpreted, and possibly the judiciary will make it difficult for the Revenue to apply this test arbitrarily. For taxpayers, there may be a more serious issue with the commercial substance test, in which the GAAR essentially imports a substance over form test. This test could have been left to be developed by the courts, but in this instance, the government additionally included certain deeming regulations.

An arrangement is considered to lack commercial substance if, among other things, it involves the location of an asset, a transaction, or the residence of any party has no significant commercial purpose other than to provide a party with a tax benefit. Since it is a deeming provision, it can capture transactions even if their economics are otherwise legitimate. For instance, the Revenue could use these criteria to identify *Sanofi*-like structures because it could be alleged that ShanH only resided in France to obtain benefit from tax relief from India under the India-France DTAA.

A DTAA and the GAAR's interplay is a complex topic, but it generally works in the GAAR's favour. Unlike the 2012 indirect transfer amendments Section 95 of the GAAR provisions (which reads "notwithstanding anything contained in the Act") contains a non-obstante clause. Furthermore, according to section 90 (2A)[984], GAAR would take precedence over any beneficial provisions in a DTAA to which India is a party. The combination of these two clauses ensures that GAAR can circumvent any DTAA's defences. It appears that the Revenue may be able to use the GAAR to question even those entities whose residences have been cleared under a DTAA's "Limitation of Benefits" clause.

The Supreme Court had been hearing an appeal in the *Sanofi* case, and the appeal has been withdrawn by the Revenue recently. The grandfathering provisions of the GAAR will probably not apply when the Supreme Court rules on the *Sanofi* case in the future. However, it would be fascinating to examine how the Supreme Court would handle a GAAR challenge in light of current DTAA rules if another *Sanofi*-like circumstance were to occur in the future. The AP High Court had hinted at a strategy that would allow for the adoption of GAAR provisions over DTAA advantages by noting the non-obstante nature of GAAR provision. However, the taxpayers might argue that, if domestic law were to be applied to affect the operation of the DIAA, the DTAA must be interpreted according to the state of the domestic law prevailing at the time the treaty was signed. Otherwise, the application of GAAR to deny treaty benefits would amount to a breach of an international agreement. It remains to be seen whether the Supreme Court will accede to this argument.

The OECD BEPS process gained momentum when the GAAR went into effect and concluded in the MLI. Most of its signatories have agreed to add anti-avoidance language in their respective DTAAs as a result of the MLI. Despite the fact that the actual language of the anti-avoidance provisions may vary from one DTAA to another for reasons of convenience. This chapter will concentrate on the principle purpose clauses (PPT rule) supported by the MLI, the wording of which is phrased as follows:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention 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 purpose 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 this convention."

The question is whether the revenue's claims about tax avoidance in the *Sanofi* case may be revived in light of the PPT rule. In other words, is the PPT rule the deliverance from the judicial inertia on tax avoidance that the revenue was

[984] Income Tax Act, 1961, § 90, No. 43, Acts of Parliament, 1961

waiting for? The PPT rule seems to be more stringent than the analogous GAAR provision in the ITA. The PPT rule's trigger is whether one of the primary reasons of an arrangement was to avoid taxes by utilising the relevant DTAA, whereas the GAAR's trigger is whether the primary objective of an arrangement is to obtain a tax benefit.

CONCLUSION

Capital gains have always been subject to creative tax planning in the case of transfers of shares of companies. With respect to jurisdictions such as India, for a long time, there was a practice of transferring control over Indian companies indirectly by transferring the shares of their holding companies overseas. For example, an American company would hold the shares of a Cayman Islands company, which in turn would hold the shares of an Indian company. If the American company was approached by a buyer interested in the Indian company, the American company would sell the shares of the Cayman Islands company and thus transfer control over] the Indian company indirectly. As is well known, this method of executing India related sales was made possible because of a peculiarity in the Indian nexus rules char allowed foreign incorporated companies to have their *Situs* outside India even if it were the case that these companies held, substantially, Indian *Situs* properties.

Another method of reducing or eliminating Indian taxation on capital gains was to hold Indian companies through companies in jurisdictions that had a favourable DTAA with India. For example, an American company would hold the shares of a Mauritius company (before the amendment of the India Mauritius DTAA in 2016) that would, in turn, hold the shares of an Indian company. The American company would cash out the increase in the value of the Indian company by having its Mauritius subsidiary transfer the Indian company's shares. The India-Mauritius PTAA, in its pre 2016 avatar, allocated capital gains mainly to the residence country of the shareholders, which meant that only Mauritius would have the right to tax the ale. The availability of DTAAs, such as the ones in Mauritius, was accompanied by a liberal judicial attitude encapsulated in the *Azadi Bachao Andolan* case, which held chat even companies without a substantial business presence in Mauritius could take advantage of the DTAA.

The upshot of the two trends mentioned above was that there was an impression created that the tax strategies in the capital gains arena were unjustifiable tax avoidance arrangements and needed to be addressed directly. Two kinds of strategies were pursued by the Indian government. At the domestic level, the government amended the ITA to change the nexus rules: shares of foreign companies with substantial Indian property were held to be situated in India for capital gains purposes. In addition to the 'nexus amendments, the government also amended the definitions of 'transfer' and 'property'. These amendments are of significance because they catch de facto transfers of control over companies, thus opening up a new avenue for the imposition of taxes over the indirect transfers of Indian company shares, while at the same time making such impositions vulnerable to failures because of the difficulty in calculating capital gains in such instances.

At the international level, the government negotiated with jurisdictions such as Mauritius and Singapore to modify the capital gains allocation provisions in favour of India: the provisions now give India the right to tax capital gains in situations of indirect transfers. However, there are jurisdictions with which India has signed DIAAs that continue to have capital gains allocations that favour the residency countries. Such jurisdictions continue the potential of Indian tax avoidance of capital gains. If a resident investor from such a jurisdiction transfers the shares of an Indian company, the investor will not be taxed in India. Examples of such jurisdictions are France and Netherlands.

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The famous *Sanofi* case was decided in the context of the capital gains allocation provisions in the India-France DTAA. *Sanofi* involved the sale of a French company by one French resident to another French resident. The only Indian connection was that the French company, the shares of which were being transferred, held all the shares of an Indian company. The reason for the sale was the transfer of control over the Indian company. The sellers and the purchasers took the position that the India-France DTAA protected this sale from Indian capital gains taxation because the treaty allocated capital gain in the case of shares of French companies to the residence jurisdiction of the seller. Except in the situation where the alienation was with reference to more than ten percent of the shares of an Indian company.

The Revenue argued that the entire transaction was a tax avoidance transaction and the existence of a French company that held the shares of the Indian company had to be ignored. If the existence of the French company were to be ignored, then the sale would be re-characterised as a sale of an Indian Company's shares (rather than French company's share) and as a consequence, subject to Indian capital gains taxation. This strategy of Revenue was a mistake. Indian courts after *Azadi Bachao Andolan and Vodafone,* are reluctant to pierce an corporate veil except in the rare case of fraud or usurpation of the power se management of a corporate entity by another person.

What is more interesting is to test if the Revenue would have succeeded with alternate arguments that did not rely on disregarding corporate entities for tax purposes, particularly in the new tax climate after the introduction of the GAAR and PPT clause. The Revenue did argue that after the 2012 amendments to the definitions of transfer', alienation' under the India-France DTAA can be read more liberally to include an indirect transfer of an Indian company's shares. The court rejected this argument on various grounds. First, 'alienation' was not identical to transfer, and therefore, the changes to the definition of 'transfer were not relevant to an understanding of the meaning of alienation. Second, the retrospective amendments to the definitions in the domestic tax legislation must not be allowed to unilaterally result in a change in the interpretation of tax treaties. Finally, taxing indirect transfers of shares by treating control or management rights over Indian companies as an asset will lead to problems of calculation of consideration and costs that will invalidate the capital gains charge.

Sanofi was decided before GAAR and the BEPS project. The GAR provisions expressly override other provisions in the ITA, including tax effects flowing from any DTAA. After GAAR, it is arguable that the *Sanofi* facts might trigger one of the features that are tagged as impermissible tax avoidance, particularly the feature of using a tax jurisdiction in order to save on Indian taxes. However, the GAAR is applicable only if the main purpose of an arrangement is to obtain a tax benefit and taxpayers can take the position that in a *Sanofi* like situation, tax is only one of the purposes of the commercial arrangements in question. Tax efficiency was an important element in the *Sanofi* facts, but it was not the main purpose of the arrangement. The main purpose of the arrangement was to invest in the pharmaceutical business in India with a view to exit the business in the future.

The introduction of the PPT clause can lead to complications that are different from those arising out of the GAAR. The PPT clause is trigged if one of the main purposes of an arrangement is to take advantage of a DTAA, thus potentially capturing situations where tax savings was an important consideration in addition to commercial objectives. However, the PPT clause allows for arrangements that are in line with the purposes of the DTAA, thus allowing taxpayers to argue in *Sanofi* like situations that since the French taxes (which were quite substantial and comparable Indian taxes) had been paid on the transaction, there was no intention to fashion Ale transaction towards no taxation or low taxation, and hence, the

transaction is in the with the objectives of the TAAs which are to avoid egregious tax avoidance (low taxation or no taxation). The tax situation becomes more complicated in the cases of jurisdictions that allocate capital gains tax in the case of indirect transfers to residence countries, and the residence country has zero or low tax rates for capital gains. In such a case, the PPT clause might be potentially applicable to *Sanofi* like arrangements. Capital gains allocation provisions in DTAAs have always been a rich source of controversy. The Indian Revenue has appealed the *Sanofi* decision to the Supreme Court, and a decision on the most appropriate interpretation of the India France DTAA is awaited. Indian tax jurisprudence on capital gains under tax treaties will continue to evolve in the future.