

# A Critical Appreciation of International Tax Law

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Honourable Justice Jain, Honourable Justice Dr. Srikrishna, President Thakkar, Secretary Dubash, Mr. Engineer, esteemed seniors and members of the Bombay Bar Association, and dear friends, I am grateful for your invitation to share my critical appreciation of international tax law in India.

It is truly an honour to be delivering this lecture here, as it was here, at the Bombay High Court, that my now 18-year-old relationship with international tax law began, when Mr. Chagla was arguing the Vodafone case before Justice Radhakrishnan and Justice Nirgude.

The subject before us, is not only vast, but also rather technical, and I recognize that the audience today is a healthy mix of specialists and those who are here out of sheer curiosity. Therefore, I shall endeavour to make today's subject both approachable and pithy to engage everyone.

To this end, I have divided this lecture in two parts: first, I shall deal with certain building blocks of international tax law. The second part could be called "Black & White or Grey?", in which I shall examine two case laws critically.

So, let us start with the building blocks.

The expression "international tax" is really a misnomer. There is no international tax body which imposes a supra-national tax. The term refers merely to national taxes applied to cross-border income or capital. Whilst countries are free, within their constitutional limits, to impose taxes on any income earned by any person by way of their domestic laws, the unrestricted imposition of such taxes would result in overlapping tax claims by two or more countries. This phenomenon is referred to as juridical double taxation.

To quote the OECD, "its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries".

Although such double taxation could, in theory, be relieved unilaterally by the country of which the taxpayer is a resident, this is not always the case in practice. One of the other issues with unilateral relief is that the burden of relieving double taxation falls solely on one country. This is where income tax treaties — instruments of international law concerning direct taxation — come into the picture. These treaties form the bedrock of the "international law on taxation", or "international tax law".

Bilateral tax treaties, which have been in a state of gradual, but constant, evolution over the past century and a half, are designed in a manner that *both* contracting states share the burden of resolving double taxation. Modern tax treaties are based fundamentally on what is colloquially called *a distribution of taxing rights* amongst the contracting states in accordance with certain notions of "economic allegiance" or "nexus".

As a side note, these norms of economic allegiance or nexus were developed a long time

ago in the 1920's by the League of Nations. There is widespread consensus that change is necessary. Not for the want of effort, however, there is no consensus yet on what this change should be. But I digress. This lecture is not about what the law ought to be, but rather what the law currently is, and how it should be interpreted and implemented. So, how do tax treaties interact with the Income-tax Act of 1961? That is the fundamental question I seek to address in the first part of this lecture.

As you know, treaty making power vests exclusively in the Executive under Article 73(1) of the Constitution of India. Article 253 empowers Parliament with the authority to implement treaties. Usually, this translates to a treaty being negotiated and concluded by executive, which is thereafter ratified and implemented by Parliament.

However, tax treaties are different. Section 90(1) of the Income-tax Act delegates the authority to conclude tax treaties to the Central Government. Section 90(2) on the other hand pre-ratifies the implementation of such tax treaties by stating that the provisions of the Act shall apply to an assessee to whom such a treaty applies, only in so far as they, *i.e.*, the provisions of the Act, are more beneficial to her.

The obvious question arises: In what way can the provisions of the Act be more beneficial than those of a tax treaty or vice versa. Two things must be comparable for one of them to be more beneficial than the other. But do the Income-tax Act and tax treaties perform the same functions for them to be comparable?

The decision of the special bench of the Income Tax Appellate Tribunal in *Motorola v. DCIT*, [2005] 147 Taxman 39, is cited often to suggest that tax treaties provide an alternative tax regime to the Income-tax Act. A similar sentiment was expressed by the Andhra Pradesh High Court in *Sanofi Pasteur*, [2013] 354 ITR 316.

The notion of an "alternative tax regime" may conjure images of a tax code, replete with provisions dealing with the computation of income, the attribution of income to a taxpayer, the creation of a charge of tax at prescribed rates, exemption provisions, etc.

However, tax treaties do none of this. Despite the colloquial aphorism that tax treaties allocate

taxing rights, a closer examination reveals that they only set limits to a country's sovereign right to tax income.

The starting point of any tax treaty analysis, therefore, must be the domestic tax law of a country, the Income-tax Act of 1961 in India's case. Only after these domestic tax claims have been computed fully can one determine the extent to which a tax treaty restricts them.

This process may seem superfluous and unnecessarily tedious to a tax advisor in a hurry, who may wish to begin and end their analysis with tax treaties. That approach may not be problematic in cases where a tax treaty restricts India's tax claims completely. However, there may be instances in which the hasty approach yields outcomes that are not only incorrect, but may also be rather expensive to the taxpayer.

Such a potential situation arose in the recent case of *Hyosung Corporation* decided by the Income Tax Appellate Tribunal.

Here are the facts of the case, which I have tweaked slightly to illustrate my point. In this case a company which is a resident of Korea earns 80 of fees for technical services arising in India. These fees for technical services are not attributable to the taxpayer's permanent establishment in India. Brought forward losses of 50 are attributable to the permanent establishment. Under the Income-tax Act, both streams of income fall within the head of *profits and gains of business or profession*. Under domestic law, therefore, only 30 of the taxpayer's net income may be subjected to a withholding tax of 20 per cent. This equates to a tax liability of 6 on the taxpayer.

Now, let us look at the tax treaty. Article 12 of the Korea-India tax treaty states:

- 1) [...] fees for technical services [arising in India] and paid to a resident of Korea may be taxed in Korea.
- 2) However, such [...] fees for technical services may also be taxed in India, and according to the laws of India, but if the beneficial owner of the fees for technical services is a resident of Korea, the tax so charged shall not exceed ten per cent of the gross amount of the fees for technical services.

It is often said that tax treaties create a charge by prescribing a withholding tax rate on certain streams of income like fees for technical services. However, a closer look at Article 12(2) reveals that it prescribes neither the amount of income taxable nor the rate of tax applicable but merely a limit on the amount of tax that may be levied in India on fees for technical services. In these facts the limit would be 10 per cent on the 80 of gross which leads to tax bill of 8.

Even though the domestic withholding tax rate of 20 per cent was greater than the 10 per cent stated in the tax treaty, the final tax bill of 6 under the domestic law is within the treaty limit, and is not restricted by the treaty.

Not for a moment do I suggest that the term more beneficial is meaningless even if it may be superfluous. The correct way to interpret Section 90(2), I submit is that the provisions of the Act are applicable to a taxpayer to the extent they are not restricted by a tax treaty.

Another intuitively appealing, but inaccurate, idea is that the definition of a term in a tax treaty may be more beneficial than the domestic law meaning of that term. This idea appears to have been approved in an *obiter dictum* of the Supreme Court of India in the famous case of *Engineering Analysis*, [2021] 432 ITR 471. At paragraph 100, Justice Nariman states:

any ruling on the more expansive language contained in the Explanations to Section 9(1)(vi) of the Income Tax Act would have to be ignored if it is wider and less beneficial to the assessee than the definition contained in the DTAA, as per Section 90(2) of the Income Tax Act.

With due respect, the fallacy of this *obiter dictum* becomes apparent once we read the treaty definition of royalties. The definition in Article 12(3) of the US-India tax treaty begins with the expression “the term “royalties” as used in this Article means: . . .”. The term “royalty” in the Act has been defined in Explanation 2 to Section 9(1)(vi) starting with the words “For the purposes of this clause, “royalty” means . . .”. Even though the terms “royalty” and “royalties” are similar they may mean one thing for the purpose of the Act which is the starting point, and another thing entirely for treaty purposes which then restricts

the domestic tax claims. But the two definitions, do not necessarily interact.

This is not to say that there can be no interaction between terms used in a treaty and their domestic law meanings at all. According to Article 3(2), a term used, but not defined in a treaty, unless the context otherwise requires, has the meaning that it has under the law of the State applying the tax treaty, at the time of the application of a tax treaty. Given that the reference to the domestic law is dynamic, countries can and do tend to become creative by changing their domestic laws so as to gain more taxing rights than contemplated in the treaty. India has been one such creative country.

Most tax treaties define the term royalties to include payments “for the use, or the right to use, a secret formula or process”. Although, the term is part of a definition, “secret formula or process” is not itself defined in the treaty. Under the rule of Article 3(2) that undefined term must derive its meaning from domestic law, “unless the context otherwise requires”. The international consensus reflected in the OECD commentaries is clear. The adjective “secret” qualifies not only the noun “formula” but also the noun “process”. Therefore, payments for the use of a “process”, which is not a “secret process”, may not be characterised as “royalties”.

Let me contextualise this with the use of a hypothetical. Consider a company which is a resident of the Netherlands, which allows an Indian broadcasting company to use the transponder capacity on one of its satellites. The consideration payable for the use of this capacity may be characterised as payments for the use of a process. Now, most people who paid attention in their physics classes in high school would know the process of reflection of radio waves used for satellite communication. The engineering may be complex, but the process is not a secret. Can the consideration paid by the Indian company to the Dutch company be characterised as “royalties”?

The issue is controversial in Indian case law. On the one hand, the Delhi High Court in *DIT v. New Skies Satellite B.V.* 382 ITR 114 was in consonance with the international consensus. The process ought to be a secret process. The Madras High Court, on the other hand, in *Verizon Communication Singapore v. ITO* 361 ITR 575

concluded otherwise. The issue is now pending before the Supreme Court.

India, in the meantime, has been creative by inserting a retrospective explanation which states that the term "secret" applies only to "formula" and not to "process".

Reading Article 3(2) strictly, the treaty meaning would follow the domestic law meaning, unless the context requires otherwise. This is especially problematic because Article 3(2) refers to the domestic law dynamically, and not the domestic law as it was at the time the treaty was concluded. The question therefore is: Can India alter the allocation of taxing rights unilaterally by altering the domestic law meaning of an undefined treaty term? Or does the context require otherwise? And how do we determine whether such context exists?

There are many ways of determining context. One is particularly useful for the instant controversy of transponder capacities. The Netherlands-India tax treaty is concluded not only in English, but also in Hindi and in Dutch. Each of these versions is equally authentic. Let us see if the Hindi or the Dutch version of the treaty is useful in providing context. The Hindi version uses the term "गुप्त फार्मूला या प्रक्रिया", which is not particularly helpful in this regard. The Dutch text, uses the expression "*een geheim recept of een geheime werkwijze*", which translates to "a secret formula or a secret process". This text reflects the clear intention of the contracting states that only payments for secret processes should be characterised as "royalties".

It would be intellectually dishonest of me if I do not point out that the concluding part of the Netherlands-India tax treaty states that whilst all language versions are equally authentic, in case of a divergence between the Dutch and Hindi texts, the English text shall be operative. But does such a divergence exist within the Dutch and the Hindi texts? Should a divergence be said to exist at the slightest difference in wording, or should a reconciliation be made where it is possible to discover a common meaning?

I submit the latter for the following reasons: First, the English and the Hindi usages of "secret formula or process" or "गुप्त फार्मूला या प्रक्रिया" can be ordinarily interpreted as meaning "secret formula or secret process". Secondly, the double

use of the term "secret" in the Dutch text is a consequence of Dutch grammar. Nouns in Dutch are either gendered or not. Non-gendered nouns are preceded by the definite article "*het*" whereas gendered nouns are preceded by the definite article "*de*". Adjectives qualifying nongendered or *het* nouns do not carry an "e" at the end, whereas gendered or *de* nouns are qualified by adjectives with an appended "e". The Dutch noun "*recept*" i.e. "*formula*" is a non-gendered noun and must be qualified by the adjective "*geheim*", whereas the noun "*werkwijze*" is feminine, and must be qualified by the adjective "*geheime*". Given these linguistic requirements, the Dutch text of the treaty could not have been drafted differently. As long as such language does not contradict the Hindi or the English versions, no divergence should be construed so as to ignore the clear Dutch text in favour of the artificially ambiguous Hindi and English text.

Thirdly, India's treaty with the Netherlands is not an exception. The Dutch version of India's treaty with Belgium uses exactly the same terminology. Fourthly, Dutch is not the only non-English, non-Hindi text which gives us this meaning. The French adjective "*secrets*" in "*secrets d'une formule ou d'un procédé*" and the German adjective "*geheimen*" in "*geheimen Formeln oder Verfahren*" are in the plural in every Indian tax treaty concluded with Francophone and German speaking country. The same is true for the French version of the OECD Model. This proves beyond any doubt that the treaty context requires that the term "secret formula or process" to mean secret formula or *secret* process. Therefore, payments for the use of non-secret processes like that of the satellite transponder cannot be characterised as "royalties" for treaty purposes despite the reference to domestic law under Article 3(2).

Unfortunately, this aspect of tax treaties being concluded in different languages has never been examined by courts in India, perhaps because the argument was never placed before it. One does hope that the exercise of treaty interpretation by courts in India evolves to adopt a holistic approach of evidence-based interpretation as opposed to rhetorical interpretation.

We have now reached the mid-point of this lecture and we may profit by restating the two building blocks discussed. First, tax treaties

operate by restricting domestic law and do not create a charge of tax by themselves. Secondly, the same or similar terms used in domestic law should not be assumed to have the same meaning. They operate on different planes and may mean different things within each of those planes.

Let us now come to part two which is titled “Black & White or Grey?”. The first case I shall examine critically is the Andhra Pradesh High Court decision in *Sanofi Pasteur* which I have already referred to earlier. In this case, a company which was a resident of France earned capital gains from the sale of shares in a company which was also a resident of France. Those shares derived their value substantially from the shares of a company which was a resident of India. In simple terms, the transferor earned capital gains from the indirect transfer of the shares of the Indian company.

Capital Gains earned by a non-resident are taxable in India if they are derived, directly or indirectly, from the transfer of a capital asset situated in India. Explanation 5 to Section 9(1)(i) of the Income-tax Act was inserted retrospectively to state that shares in a foreign company which derived their value substantially from assets located in India are deemed to be situated in India. Therefore, under domestic law the capital gains from the sale of shares of the second company were taxable in India.

The question then arises whether the France-India tax treaty restricted India from taxing the capital gains. Let us refer to the text of the Article 14(5) of the France-India tax treaty, which is the relevant distributive rule in this scenario.

(5) Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least 10 percent in a company which is a resident of a Contracting State may be taxed in that Contracting State.

Let us read this provision by replacing the term “contracting state” with the names of the countries. Assuming that the 10 per cent threshold is satisfied and the shares do not fall within the scope of paragraph 4, the provision would read: Gains from the alienation of shares in a company which is a resident of France may be taxed in France. The question we must ask, if we

remember the first building block, is does paragraph 4 restrict India from taxing the capital gains? The answer is no. Interpreting solely Article 14, nothing in it restricts India from taxing the capital gains.

The Andhra Pradesh High Court, however, concluded that Article 14(5) “in clear, unambiguous and explicit terms allocates the resultant capital gains tax to France”.

Respectfully, the High Court committed the error of asking whether the treaty allocated taxing rights to a country, instead of adhering to the first building block and asking whether the France-India tax treaty restricted India from taxing the gains. Some may argue that the term “may be taxed in France” in Article 14(4) should be interpreted to mean “shall be taxable only in France”. To them I should point out to Article 14(6) of the France-India tax treaty.

(6) Gains from the alienation of any property other than that mentioned in paragraphs 1, 2, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

This distributive rule like many of those across the tax treaty employs the expression “shall be taxable only”, when it was so intended. Some, as did the Andhra Pradesh High Court, would recite Justice Srikrishna’s citation of Francis Bennion in *Azaadi Bachao Andolan*. Bennion stated famously that “the drafting of treaties is notoriously sloppy usually for very good reason”. This citation which was not so much as a part of the *ratio decidendi* of *Azadi* appears to have been accepted as gospel truth by courts in India whilst interpreting tax treaties. Therefore, they suggest, that tax treaties should be interpreted liberally in the favour of the taxpayer. However, this is a fallacy. Whilst Bennion’s proclamation may be true for certain types of treaties, it does not apply to tax treaties. Tax treaties are based on the OECD Model Tax Convention which, despite its issues, is a finely tuned instrument having undergone constant review and nine iterations over the past 62 years. The terms “may be taxed” and “shall be taxable only” are terms of art and cannot be altered by what I consider to be a wishy-washy reference to Bennion. A cursory search of the terms “Bennion” and “Sloppy” on Taxman’s

search engine throws up 180 tax cases. That is a 180 too many.

The Andhra Pradesh High Court decision in *Sanofi*, is premised on a number of fallacies and should be reviewed with a critical lens whilst advising taxpayers, and certainly whilst representing the revenue.

I must be hasty in adding that I personally believe that the outcome of *Sanofi* is correct — but for different reasons entirely. But that is perhaps for another occasion.

The next case I should like to address is the highly controversial *Assessing Officer v. Nestlé S.A.*, [2023] 458 ITR 756 (SC).

In this case the Supreme Court had the occasion to interpret a limited *most favoured nation* (MFN) provisions in the India's tax treaties with Switzerland, the Netherlands and France. Each of these MFN provisions stated that if India, after the entry into force with these respective treaties, agree with a state which is an OECD member to certain provisions which are more beneficial for the taxpayer, then India shall extend those benefits also to residents of those countries. The effect of an MFN clause would come into force at the same time as the entry into force of the more beneficial agreements with the third states.

India concluded tax treaties with Slovenia, Lithuania and Colombia, which had certain provisions for the taxation of dividends, which were more beneficial relative to India's treaties with Switzerland and the Netherlands. However, Slovenia, Lithuania, and Colombia were not OECD members at the time of conclusion of their tax treaties with India. Four or five years after the conclusion of their tax treaties with India, these countries did become OECD members. The question arose whether the MFN provision would have effect once Slovenia, Lithuania and Colombia became OECD members.

The MFN provisions however, stated that they would have effect from the date on which the third country's agreement came in force. That would be an impossibility as the third country was not an OECD member as on that day. Therefore, the court's rejection of the application of the MFN treatment insofar as the Switzerland and the Netherlands, to my mind, is flawless.

The case of *Steria*, a technology company which was a resident of France, however, was

different. They were not relying on the dividend's clause in the India's treaty with Slovenia, Lithuania or Colombia. *Steria* sought to restrict the scope of the treaty definition of *fees for technical services* on the basis of India's tax treaties with Portugal and the United Kingdom, both of which were concluded after the France-India tax treaty was. The Supreme Court rejected that argument on the ground that the effect of the MFN clause was not notified in the France-India tax treaty by the Indian Government.

The court held that an "essential requirement of a notification under Section 90 of the consequences of the trigger (or causative) event cannot be undermined". In its conclusion, the court stated as follows:

A notification under Section 90(1) is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a DTAA, or any protocol changing its terms or conditions, which has the effect of altering the existing provisions of law"

Whilst I am cognisant that the law as declared by the Supreme Court is the law of the land under Article 141 of the Constitution of India, we might profit from reading the relevant part of the actual text of Section 90(1) of the Income-tax Act which addresses the notifications.

The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India, . . . and may, by notification in the official Gazette, make such provisions as may be necessary for implementing the agreement.

Notification is not a legal requirement. Even if we read "may" as "shall", the requirement of the notification exists only "as may be necessary for implementing the agreement".

Where, I ask myself, does the *necessity* of notifying the agreements come from? Not from a unilateral practice adopted by India, and acquiesced implicitly by the other contracting states, as thought by the Supreme Court, but rather from the procedure laid down in Article 30 of the treaty itself. Once the treaty, and the protocol has been notified, they both have the force of law in India. There is no requirement,

either in Section 90(1), nor in Article 30 of the treaty, for the effect of a sovereign promise, which has already been notified, to be notified again once it comes into action.

The Supreme Court judgement in *Nestlé* is 59 pages long. There are 35 references to Section 90, and three to Section 90(1) of the Income-tax Act. However, there is no examination of the actual text of Section 90 in the judgement. It has not examined the manner in which Section 90(2) pre-implements tax treaties within the realm of law in India. Perhaps I might, with some trepidation, and with the most respect to the supremacy of the court, suggest that the part of the decision on the necessity of notifications is *per incuriam*.

I suggest it is, but I do not make this suggestion lightly. Article 141 empowers the Supreme Court to "declare" the law, but not to *enact* it. That extra-ordinary power is vested in the Supreme Court only under Article 142 with a view to doing "complete justice", in the absence of statute. The Supreme Court's proclamation of the law in *Nestlé*, I am afraid, does not fall within the scope of Article 142.

The 5-Judge Constitutional Bench of the Supreme Court in *Dhanwaty v. Commissioner* AIR 1969 SC 683 has recognised that Article 141 does empower the Supreme Court to *alter* the law to preserve harmony with the evolving social values. However, that *ratio* was declared in the context of unwritten Hindu Law, not towards the interpretation of a fiscal statute, which, it is trite to

state, must be interpreted strictly. Even generally, as can be deduced from *Supreme Court Bar Association v. Union of India* AIR 1998 SC 1895 the law-making power of the Supreme Court in Article 141 is limited to its role as problem-solver in the nebulous areas of the law without ignoring statutory provisions.

In *State v. Ratan Lal Arora* AIR 2004 SC 2364, the Supreme Court held that where in a case, the decision has been rendered without reference to statutory bars, it cannot have any precedential value, being *per incuriam*. In *Ratan Lal*, the Delhi High Court had contradicted as many as three Supreme Court judgements but followed the statute — Section 360 of the CrPC. On appeal, the Supreme Court was magnanimous to acknowledge that those three judgements had not followed the statute, and were therefore *per incuriam*, and had no precedential value.

Therefore, I restate my respectful, but critical, proposition: the Supreme Court's nonreading of Section 90 in its entirety in *Nestlé* deserves at least a close and critical inspection, and that, indeed, it may be *per incuriam*.

This is where I shall conclude my critical appreciation of international tax law in India. I hope I have been able to demonstrate to you that despite the existence of case law, the realm of international tax law is not yet black and white, but covers many shades of grey, or perhaps even a spectrum of colours. ■