INVOKING M.F.N. CLAUSE UNDER INDIAN TAX TREATIES REQUIRES NOTIFICATION

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Tags
Concentrix
D.D.T.
India
M.F.N.
Nestle
Steria
T.D.S.

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BACKGROUND

Foreign investment in Indian businesses increased significantly since the liberalization measures adopted by the Indian government in the early 1990s. Taxation played an essential role in attracting foreign investment during this period. One change made effective from April 1, 2020, was the elimination of the dividend distribution tax (the "D.D.T."). Prior to this date, dividends distributed by an Indian company were exempt from tax in India in the hands of shareholders. However, the Indian company making a distribution paid D.D.T. on the amount distributed. Effective from April 1, 2020, the concept of D.D.T. was abolished, and dividend income became taxable in the hands of shareholders.

T.D.S.

Indian companies are now required to withhold tax at source ("T.D.S.") when distributing dividends to shareholders. For dividends paid to non-resident shareholders, the rate of T.D.S. imposed under the Income-tax Act 1961 ("Act") is 20%, plus applicable surcharge and cess. A non-resident shareholder can benefit from a lower tax rate under an applicable income tax treaty. For a non-resident shareholder to claim income tax treaty benefits in India, it must furnish a tax residency certificate from its country of tax residence, along with other prescribed documentation. In addition, a non-resident shareholder must demonstrate commercial substance in its country of tax residence. In addition, it must demonstrate that the principal purpose of claiming the income tax treaty benefit is not tax evasion or tax avoidance.

Withholding Tax and M.F.N.

India's tax treaties with various countries mitigate double taxation and also reduce the scope of taxable income or lower the rate of tax in certain cases. The protocols of some of India's tax treaties include a clause known popularly as a most favoured nation ("M.F.N.") clause.

In principle, an M.F.N. clause allows the treaty partner country to import benefits from a subsequently signed Indian income tax treaty when certain conditions are met. To illustrate, India's tax treaties with the Netherlands, France, Switzerland, Spain, and several other countries allow for the application of a lower withholding tax rate in India where an income tax treaty signed by India enters into force at a later date and provides for a lower rate of Indian withholding tax or a reduced scope of taxable income, provided the treaty partner country is a member of the Organization for Economic Cooperation and Development ("O.E.C.D."). The wording of an M.F.N. clause may differ from treaty to treaty. However, a plain reading of a typical M.F.N. clause would suggest that once an income tax treaty comes into effect at a later date with another O.E.C.D. member country providing for a lower rate of withholding tax on an item of income or a reduced scope of taxable income, the M.F.N. provisions in earlier treaties will apply without further action, unless negotiation is specifically called for in a particular treaty. An example is the India-Switzerland Income Tax Treaty.

However, the invocation of an M.F.N. clause without further negotiation as to the reduction of withholding tax has not been straightforward in India. Rather, it has been debated over the years across various regions and forums in India. Depending on the relevant facts, authorities have taken divergent views on whether a protocol containing the M.F.N. clause forms part of the income tax treaty itself or applies automatically without any specific notification by the tax authorities. Also debated is whether an income tax treaty negotiated with a country that is not a member of the O.E.C.D. ("non-member country") automatically becomes an income tax treaty that can trigger the application of the M.F.N. clause in another treaty when the non-member country with the lower withholding tax rate becomes a member of the O.E.C.D.

DEFINITIVE SUPREME COURT DECISION

The issue was settled recently by the Supreme Court of India in its much awaited judgment in the matter of *Assessing Officer Circle (International Taxation) 2(2)(2) New Delhi v. M/s Nestle SA*.[1] The judgment of the Supreme Court is binding across India and is the law of the land.

In the case, the Supreme Court was asked to clarify the following two issues:

- Does the M.F.N. clause apply automatically, or does it come into effect only after notice by the Indian authorities?
- Does the M.F.N. clause in income tax treaties with countries such as the Netherlands, France, Switzerland, and Spain apply automatically when India's treaty partner is a non-member country that becomes an O.E.C.D. member at a subsequent point in time?

In this case, the M.F.N. clause applied in India's income tax treaties with the Netherlands, France, and Switzerland.

CASES AND ISSUES BEFORE THE SUPREME COURT

The balance of the article includes the following:

- A brief summary of the background of the cases
- The issues presented to the Supreme Court of India
- The legal arguments of the taxpayers and the tax authorities
- The judgment of the Supreme Court
- The likely effect on other taxpayers if the case is not reconsidered

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1 TS-616-SC-2023.

Concentrix Services Netherlands BV

The taxpayer was a tax resident of the Netherlands and a shareholder of several Indian companies that distributed dividends in years after the abolishment of the D.D.T. The tax rate on dividend income under the India-Netherlands Income Tax Treaty was 10%. However, the taxpayer made an application to the Indian tax authorities seeking to invoke the M.F.N. clause under the India-Netherlands Income Tax Treaty, which was signed in 1989. The taxpayer contended that the lower tax rate of 5% for dividend income provided in India's income tax treaties with Slovenia (signed in 2003), Lithuania (signed in 2011), and Columbia (signed in 2011) was imported into the India-Netherlands Income Tax Treaty under the M.F.N. clause. Slovenia, Lithuania, and Colombia were not O.E.C.D. members when their income tax treaties with India were negotiated, but each was an O.E.C.D. member on the date the application for a 5% withholding was submitted to the Indian tax authorities.

"In essence, it held that the point in time when the status of a treaty partner country as an O.E.C.D. member is not the time of signing the income tax treaty, but rather is the time of the distribution."

The tax authorities denied the application of the 5% tax rate on the ground that Slovenia, Lithuania, and Colombia were not O.E.C.D. members when their income tax treaties with India were signed. Slovenia became an O.E.C.D. member in August 2010, Lithuania became an O.E.C.D. member in July 2018, and Colombia became an O.E.C.D. member in April 2020. Consequently, Concentrix could not invoke the M.F.N. provision in the India-Netherlands Income Tax Treaty. The predicate condition for obtaining the requested M.F.N. benefit was not met; none was a member of the O.E.C.D. when the India-Netherlands Income Tax Treaty was signed.

The Delhi High Court, however, held that the benefit of the lower tax rate of 5% for dividend income under each of these tax treaties was available to Concentrix, a tax resident of the Netherlands. In essence, it held that the point in time when the status of a treaty partner country as an O.E.C.D. member is important is not the time of signing the income tax treaty, but rather is the time of the distribution. The Netherlands adopted that view in an earlier pronouncement, stating that the rate of withholding tax on intercompany dividends paid by a Dutch resident company to a company resident in India would be the lower tax rate of 5% that applies under the India-Slovenia Income Tax Treaty. According to the Delhi High Court, India cannot take a contrary stand in light of the decree and the principles of interpretation of tax treaties.

Nestle SA

Under the India-Switzerland Income Tax Treaty, the rate of withholding tax on intercompany dividends is 10%. Following its earlier decision in the *Concentrix* case, the Delhi High Court gave similar access to a lower tax rate of 5% for dividends paid to Nestle SA under the M.F.N. clause of the India-Switzerland Income Tax Treaty as Nestle was a resident of Switzerland.

Again, the Delhi High Court placed reliance on the position taken by India's treaty partner country. Swiss authorities announced that they would allow a lower withholding tax rate of 5% on dividends paid to Indian residents based on the M.F.N. clause and India's income tax treaties with Lithuania and Colombia, both of which became O.E.C.D. members after the India-Switzerland Income Tax Treaty was signed. Comparable treatment by India was expected by the Swiss tax authorities.

Steria (India) Ltd.

In the *Steria (India)* case, the taxpayer referred to Clause 7 of the Protocol in the India-France Income Tax Treaty which contains an M.F.N. clause applicable to royalties, fees for technical services, and payments for the use of equipment. Steria contended that the narrower and more restrictive definition of fees for technical services under the India-U.K. Income Tax Treaty should be applied under the India-France Income Tax Treaty by reason of the M.F.N. clause. There would not be any question of withholding tax on the payment. However, the Authority of Advanced Rulings ("A.A.R.") held that unless there is a specific notification under Section 90 of the Act, the narrower restrictive clause under the India-UK Income Tax Treaty cannot be applied under the India-France Income Tax Treaty.

The taxpayer petitioned the Delhi High Court for relief. The Delhi High Court determined that a protocol is an integral component of the income tax treaty and does not require separate notification for the invocation of the M.F.N. clause.

ARGUMENTS OF THE TAX AUTHORITIES

The tax authorities first argued that Article 253 of the Indian Constitution grants the Parliament the exclusive power to legislate on any treaty or convention entered into by India. Without Parliamentary legislation, treaties are unenforceable. India follows a dualist approach, under which international treaties require legislation to be put into effect. Reliance was placed on the Supreme Court judgments in the cases of *Gramaphone Co. of India Ltd v. Birendra Bahadur Pandey & Ors*.[2] and *Union of India (UOI) & Ors. v. Azadi Bachao Andolan & Ors*[3] to support the conclusion that without enabling legislation, neither a convention nor acts flowing from a convention are operative in India.

Turning specifically to the M.F.N. in various treaties, the tax authorities argued that similar or identical treatment cannot be extended under the M.F.N. clause of the tax treaties with the Netherlands, Switzerland, and France merely because Slovenia, Lithuania, and Colombia gained membership of O.E.C.D. several years after signing beneficial tax treaties with India. Specific notification by Indian tax authorities is required before a protocol can modify an existing income tax treaty. The word "is" as used in the M.F.N. clause – *"is a member of the O.E.C.D."* – can have present, past, or future meaning, depending on the context in which it is used. Slovenia, Lithuania, and Colombia needed to be members of the O.E.C.D. at the time of entering into the respective tax treaties with India, for the Netherlands, France, and Switzerland to claim parity of treatment.

ARGUMENTS OF THE TAXPAYERS

The taxpayers argued that the tax treaties, including protocols that contain M.F.N. clauses, are already notified under Section 90(1) of the Act. Hence, no further notification is required to make M.F.N. clauses active, unless further action or bilateral negotiation is specifically called for. An example of further action that may be needed exists in a 2001 Protocol to the India-Switzerland Income Tax Treaty. It

[2] 1984 [2] SCR 664.

[3] 2003 (Supp4) SCR 222.

specifically provides for initiation of bilateral negotiation to ensure that benefits extended to states that later became O.E.C.D. members were given to Switzerland. A later protocol in 2010 partially eliminated the need to proceed through negotiation for a lower rate of tax. The need to negotiate continued for reducing the scope of taxable income. The taxpayers argued that the phrase *"shall also apply"* as used in the M.F.N. in the 2010 protocol made the application of the M.F.N. clause automatic, without any requirement to undertake bilateral negotiations or issue any notification for a lower rate of tax.

When the word "is" appears in the M.F.N. – *"is a member of the O.E.C.D."* – the word signifies the time when the provisions of the income tax treaty are to be applied (dynamic interpretation). It does not mean that O.E.C.D. membership must exist at the time when the income tax treaty is signed.

Reliance was also placed on the Supreme Court judgment in the case of *Union of India v. Agricas LLP*,[4] which held that any state cannot breach a treaty to which it is party, referring to any domestic law, which includes legislative, executive, or judicial decision.

SUPREME COURT'S JUDGMENT

The Supreme Court, relying on various judgments and interpretations of Article 253 of the Indian Constitution and Section 90 of the Act, concluded that, when India signs a treaty or protocol, it is not enforceable until Parliament enacts legislation enforcing the agreement. It is up to Parliament to decide whether the treaty should be binding or ignored. In such latter case, the Union will be in default of its obligations. To approve a treaty or a protocol, a notification is required under section 90(1) of the Act. Without such approval, a court, authority, or tribunal has no power to give effect to an income tax treaty or any protocol changing its terms or conditions.

Consequently, an M.F.N. clause does not automatically allow integration of a tax benefit granted to another country. As a result, the power of an M.F.N. clause to amend an earlier treaty requires separate notification under Section 90 of the Act.

Moreover, for a party to claim the benefit of a "same treatment" clause based on an income tax treaty between India and another O.E.C.D. member country, the relevant date for determining when countries are O.E.C.D. member countries is the date when India entered the treaty. In other words, the list of O.E.C.D. member countries is frozen on that date. Reference to tax rates in Indian income tax treaties with Slovenia), Lithuania, and Colombia is simply irrelevant.

COMMENTS

At the outset, it is important to note that, at the date of publication, newspaper reports suggest that a review petition has been filed with the Supreme Court stating that the judgment requires reconsideration for various reasons. Since the outcome of the petition is pending, we have not commented on the possibility of the Supreme Court judgment being overturned upon rehearing or stayed or modified. Any such subsequent development would be covered by way of a follow-up article.

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4 [2020] 14 SCR 372.

For now, the judgment of the Supreme Court is the law of the land and provides certainty on a topic of critical importance to non-resident taxpayers in India who seek to invoke the M.F.N. clause. The M.F.N. clause is not only applied to lower the tax rate but also to reduce the scope of taxable income for certain items, such as fees for technical services, as defined broadly to include certain equipment, and royalties.

The typical position adopted by non-resident taxpayers in the past has been that the M.F.N. clause applies automatically. Given the Supreme Court's judgment, non-resident taxpayers may find that they are subject to reassessment for transactions in prior tax periods, ranging up to 10 years.

While the primary liability to pay tax is on the non-resident recipient of income, Indian authorities tend to initiate proceedings against Indian companies having withholding tax obligations. In addition to additional tax, taxpayer/withholding agents may find that they are liable for interest and penalties. While one may argue that penalties should not be levied because reasonable cause existed in the form of the M.F.N. clauses in treaties, the additional tax and interest may still be substantial.

It is evident that the outcome of the review petition is of significant importance. One of the key principles emanating from the Supreme Court judgment is that even though treaties bind the Union, Parliament's refusal to perform or give effect to such treaties can leave the Union in default. Whether this leaves the Union exposed to an international dispute, is a matter of further analysis. Even if no international dispute arises, the tax authorities of the impacted countries – notably the Netherlands and Switzerland which anticipated reciprocal tax reductions – may consider initiating dialogue with the Indian authorities to notify the M.F.N. benefit going forward, or perhaps retroactively.

For now, it appears that impacted non-resident investors will need to brace for higher taxes in India. Affected companies may find it prudent to examine exposure to additional tax, interest, and penalties and to formulate a strategy for dealing with Indian tax examiners. This may include examining the possibility of claiming additional foreign tax credits in the recipient's country of residence. There could be cases where the country of residence does not agree with the interpretation of the Indian tax authorities – again, the Netherlands, Switzerland, and France come to mind, plus other countries that have issued notices that the M.F.N. in a relevant treaty is applicable. In that case, taxpayers may wish to invoke the mutual agreement procedure ("M.A.P.") article under an applicable tax treaty. Whichever path is taken, a prolonged battle should be anticipated.

India has not agreed to the mandatory binding arbitration article under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which when applicable, applies when treaty partners are unable to resolve issues through discussions under a relevant M.A.P.

CONCLUSION

Given the number of cases that will be impacted by the decision of the Supreme Court of India, there is likely to be a surge in assessment / reassessment, and resulting MAP cases. One can only hope that the Indian authorities will issue a clarification that provides reasonable and much-needed certainty to taxpayers.