

# Tax Hotline

October 26, 2023

## SUPREME COURT ISSUES CONTROVERSIAL DECISION IN RESPECT OF THE "MOST FAVORED NATION" CLAUSE

The Supreme Court of India has issued one of its most significant decisions on tax treaty interpretation with specific reference to Most favoured nation clauses. This decision will have far-reaching consequences on any non-resident taxpayer who has availed of the benefits of any MFN clause in any Indian tax treaty, the effect of which has not been notified explicitly by the Indian government. It is likely that these consequences will not be limited to tax claims but also interest and (potentially) penalty charges and may give rise to unrelieved double taxation. In this hotline, we take a close look at a number of controversial aspects of the Supreme Court's decision.

Recently, the Supreme Court had the occasion to interpret the Most Favored Nation ("MFN") clauses in India's tax treaties with the Netherlands<sup>1</sup>, France<sup>2</sup> and Switzerland<sup>3</sup> ("second states") in the case of *Assessing Officer Circle (International Taxation) 2(2)(2) New Delhi v. M/s Nestle SA*.<sup>4</sup> The MFN clause in a tax treaty obligates a particular contracting party to offer a more restrictive tax rate or restricted scope of income to the treaty partner as appears in its treaty concluded with a third state. Typically, but not necessarily, these pertain to withholding tax rates and scopes for dividends, royalties and fees for technical services.

The court was faced with questions of whether the MFN clauses contained in India's tax treaties with the Netherlands, France and Switzerland were triggered. According to the respective MFN provisions within each of these treaties, India must further restrict its withholding tax rates or limit the scope of the items of income to the extent provided in another agreement or convention concluded with an OECD member. The more restrictive rate or restricted scope may be agreed on via a new tax treaty or protocol to an existing treaty.

Slovenia, Lithuania, and Colombia ("third states") concluded their tax treaties with India before they became OECD members. The timeline of the conclusion of their treaties with India and their accession to the OECD is provided below<sup>5</sup>:

Treaty Partner	Conclusion of Treaty	Entry Into Force (in India)	OECD Accession
Slovenia	January 13, 2003	January 1, 2006	July 21, 2010
Lithuania	July 26, 2011	April 1, 2013	July 5, 2018
Colombia	May 13, 2011	April 1, 2015	April 28, 2020

It followed from the Delhi High Court decisions in *Concentrix*<sup>6</sup> and *Nestle*<sup>7</sup> that the 5% withholding tax rate would be available to Dutch, French and Swiss resident companies from July 21, 2010, if they owned at least 10% of the shares of an Indian company paying dividends. The 10% shareholding threshold would have disappeared once Colombia became an OECD member, and all dividends paid by an Indian company to Dutch, French and Swiss residents would have been eligible for the 5% withholding tax rate.

The issue in the appeal in the case of *Steria*<sup>8</sup> was slightly different. In this case, the France- India treaty (entry into force: 1994) provided for a wider definition of the term fees for technical services ("FTS") than did the UK-India tax treaty (entry into force: 1993). The question, therefore, was whether the MFN clause in the French treaty would require India to apply the narrower definition of the FTS provision for the purposes of the France treaty. The Delhi High Court answered this issue in the affirmative.

The challenge before the Supreme Court posed two questions. First, whether the MFN clauses were to be interpreted in a manner to allow restrictions on tax rates (*Concentrix* and *Nestle*) and scopes of income (*Steria*) agreed between India and third states before their accession to the OECD. Secondly, whether the benefit of the restricted rate or restricted scope would automatically be available by the virtue of the MFN clause being present as part of the treaty.

## JUDGEMENT OF THE SUPREME COURT

### Timing issues - Interpretation of the term "is"

Whilst the first issue pertained to three different MFN clauses in the respective treaties with the second states, the interpretational issue was limited to understanding the term "is a member of the OECD" as it appeared in each MFN

## Research Papers

### Structuring Platform Investments in India For Foreign Investors

March 31, 2025

### India's Oil & Gas Sector— at a Glance?

March 27, 2025

### Artificial Intelligence in Healthcare

March 27, 2025

## Research Articles

### Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

### INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

### Key changes to Model Concession Agreements in the Road Sector

January 03, 2025

## Audio

### CCI's Deal Value Test

February 22, 2025

### Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

### Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

## NDA Connect

Connect with us at events, conferences and seminars.

## NDA Hotline

Click here to view Hotline archives.

## Video

Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX

clause. On this issue, the court concluded that the term "is" cannot be interpreted in a standalone manner but has to be given a meaning in the context in which it appears in the treaty. It followed that the benefit of a more restrictive tax rate or restricted scope as provided in a treaty with a third state would have been available if such a treaty is entered into with an OECD member. Therefore, the MFN clause would not allow the benefit of a restricted rate or scope appearing in India's treaty with a third state if that third state was not a member of the OECD when concluding its treaty with India. As has been suggested in academic literature,<sup>9</sup> the court's conclusion seems to be correct. Nevertheless, it is interesting to note that the court has not so much as referred to the rules of treaty interpretation in Articles 31 to 33 of the Vienna Convention on the Law of Treaties ("VCLT") whilst interpreting the term "is".

#### *Requirement to notify the effect of the MFN clause*

On the second issue, the court observed that the benefit of a more restrictive tax rate or restricted scope in the treaty with a third state would be available via the MFN clause only if it were specifically notified by the central government. Therefore, a more restrictive tax rate or restricted scope of income in a treaty with a third state would not be automatically available to the second state. The court reached this conclusion by reference to Article 31(3)(b) of the VCLT. Article 31(3)(b), which is merely a part of the general rule of interpretation, requires that a subsequent practice *shall be taken into account* along with the context, object and purpose whilst interpreting the treaty. Such a subsequent practice must "*establish the agreement of the parties* regarding its interpretation". The court observed that India has had a consistent practice of undertaking a separate notification to allow a more restrictive rate or restricted scope in treaties with third states to be availed by a second state.

### CONCLUDING COMMENTS AND IMPACT ASSESSMENT

A tax treaty should be interpreted in good faith, and in light of its object and purpose. Article 31 of the VCLT provides for the general *rule* of interpretation. Therefore, the entirety of Article 31 ought to be applied to interpret a treaty as the various elements within the provision form part of a singular rule of interpretation. The court has looked at Article 31(3)(b) in a vacuum, rather than applying the entire rule of interpretation. This approach raises the question of whether the decision was in good faith.

The impact of this decision is wider than the timing issues that arose from the decisions of the Delhi High Court in *Concentrix* and *Nestle*. It may affect every non-resident taxpayer (and persons responsible for withholding taxes) who has so far taken advantage of any MFN clause contained in any Indian tax treaty, the effect of which has not been notified by the Indian government except to the extent such taxpayers' assessment is barred by time. It is likely that these consequences will not be limited to retroactive tax claims. Whilst penalty charges may not be sustainable because the issues raise substantial question of law which needed adjudication by the Supreme Court, the retroactive tax claims may be expected to attract interest charges. These consequences could pose challenges to a business's cash flows.

The Supreme Court's decision seems to represent a unilateral interpretation of a bilateral treaty provision. This raises the additional question of whether the other contracting states will provide an additional credit to relieve the double taxation that is otherwise bound to arise.

— **Anirudh Srinivasan** and **Dr. Dhruv Janssen-Sanghavi**

You can direct your queries or comments to the authors.

<sup>1</sup>Article IV of the Protocol to the Netherlands-India tax treaty.

<sup>2</sup>Paragraph 7 of the Protocol to the France-India tax treaty.

<sup>3</sup>Paragraph 5 of the Protocol to the Swiss-India tax treaty.

<sup>4</sup>CIVIL APPEAL NO(S). 1420 OF 2023.

<sup>5</sup>Dhruv Janssen-Sanghavi, "Concentrix : A Critical Review of the Delhi High Court's Ruling On the Interpretation of the India-Netherlands Tax Treaty", (2021) 104 Tax Notes International 9 pp. 1033 - 1038, available at <https://ssrn.com/abstract=3997048> (accessed 26 October 2023).

<sup>6</sup>Concentrix Services Netherlands B.V. v. ITO (TDS), 434 ITR 516 (Delhi).

<sup>7</sup>M/S Nestle SA vs Assessing Officer Circle (International Taxation), W.P.(C) 3243/2021.

<sup>8</sup>Steria (India) Ltd. vs. Commissioner of Income-tax-VI, [2016] 386 ITR 390 (Delhi).

<sup>9</sup>See: Dhruv Janssen-Sanghavi, footnote 5 above; Ashish Karundia, "Application of Most Favoured Nation Clause of the India-Netherlands Treaty — Requires Reconsideration," 127 taxmann.com 14 (2021).

### DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.