

Tax Hotline

February 07, 2022

MOST FAVORED NATION CLAUSES IN INDIA TAX TREATIES – A CONTINUING SAGA

The Central Board of Direct Taxes (“**CBDT**”) issued a circular last week (February 03, 2022) clarifying the applicability of Most-Favored Nation (“**MFN**”) clauses in tax treaties of India with certain jurisdictions (“**Circular**”).¹

The effect of an MFN clause is that one state obligates itself to its treaty partner with respect to offering it a ‘more favourable’ tax treatment (than what is set out in their own tax treaty), if such ‘more favourable’ tax treatment is offered by the first state in its tax treaty provisions with a different third state. Both, the second and the third states will need to be OECD members for the MFN to apply.

The rationale is for all members of the OECD to be afforded similar treatment in their tax treaties with the same country.

OPERABILITY OF MFN CLAUSES

By way of an example, if the source jurisdiction’s (State A) right to tax dividends is restricted to 15% in the treaty between State A and B (assuming that the Protocol between State A and B contains an MFN clause); and State A enters into a treaty with State C (who is also an OECD member) wherein source jurisdiction’s (State A) right to tax dividends has been restricted to 5%, then the same favorable treatment (i.e., 5% rate) must be applicable on dividend taxation between States A and B as well. Note that for an MFN clause to apply, both states B and C will need to be members of the OECD. An important note is that the language of MFN clauses obligates the source jurisdiction (i.e., State A) to offer the more favorable treatment while withholding taxes on certain items (such as royalties, dividends, interest, fee for technical services).

However, a contentious issue arises with respect to the applicability of the MFN clause. Consider the example set out below:

- Protocol to State A and B’s tax treaty contains an MFN clause. The source jurisdiction’s right to tax dividends is restricted to 15% as per the treaty.
- State A enters into a treaty with State C who is not an OECD member at the time when the treaty between them comes into force. Tax treaty between State A and C restricts the source jurisdiction’s right to tax dividends at 5%. Given that State C is not an OECD member, despite having a more favorable treatment in this treaty between States A and C, the MFN clause between State A and any other country will not come into effect.
- However, State C subsequently becomes an OECD member at a later date.

In such circumstances, does the MFN clause between States A and B still come into effect (resulting in the more favorable rate (i.e., 5%), also being applicable to the treaty between States A and B)?

RELEVANCE TO INDIA

This question has gained significance over the last decade, in the context of several treaties entered into between India and certain OECD countries. Specifically, the Protocol to India’s treaties with Netherlands, France and Switzerland, all contain MFN clauses that are applicable from the date when India signs a tax treaty with another OECD member, while offering a more favorable treatment. India’s right to withhold taxes on dividends is restricted to 10-15% in these treaties.

On the other hand, India’s treaties with Slovenia, Lithuania, and Colombia restrict India’s right to withhold taxes on dividends paid at the rate of 5%, if the beneficial owner of the dividend is a resident of the other state. However, these countries were not members of the OECD at the time these treaties were entered into force; and only acceded to the OECD at a much later date.

- India-Slovenia tax treaty: Entered into effect in 2006; joined the OECD in 2010.
- India-Lithuania tax treaty: Entered into effect in 2013; joined the OECD in 2018.
- India-Colombia tax treaty: Entered into effect in 2015; joined OECD in 2020.

Consequently, France, Netherlands, and Switzerland have released unilateral directives dated 2016, 2012, and 2021 respectively, declaring that the tax rates on dividends under the respective tax treaties with India stand modified by way of the MFN clause, after India entered into a tax treaty with Slovenia (which became a member of the OECD in 2010). As such, the directives set out that the 5% withholding tax rate on dividends (if the holding is above 10%) as set out in the India-Slovenia treaty, should modify the maximum rate of withholding in case of dividends (as under

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their respective treaties) to 5% as well. The directives of France and Netherlands further set out that the 'more favorable' rate is to apply retrospectively from the dates that Slovenia became a member of the OECD (rather from the date India – Slovenia treaty came into force). Similarly, the directive from Switzerland sets out the 'more favorable' treatment (as per the India-Lithuania treaty) to apply from Lithuania's date of joining the OECD (2018); and the 'more favorable' treatment (as per the India-Colombia treaty) to apply from Colombia's date of joining the OECD (2020).

The question that arises, is whether the MFN clause entered into between India and the OECD members (France, Switzerland and Netherlands) has the effect of further restricting India's right to withhold taxes on dividend (below the rates said out in their respective treaties), if India enters into a treaty (setting out a lower rate) with a third country which is not an OECD member at the time of the treaty coming into force, but becomes an OECD member at a later date. While this question has been answered in favor of the taxpayer in a few decisions by the Delhi High Court ("**Delhi HC**") (explained herein after), the position has been vehemently and consistently opposed by the India tax department ("**Revenue**"). It must also be noted that India has communicated its position to all three jurisdictions stating that the lower rate cannot be imported through an MFN clause, as Slovenia, Colombia, and Lithuania were not members of the OECD *at the time* when India entered into the respective tax treaties with them; but has not received any responses to India's interpretation.

In context of the rulings from the Delhi HC, and in response to the unilateral directives issued, the Ministry of Finance (through the CBDT Circular dated February 03, 2022), has clarified that the 'more favorable' rates on dividend taxation within India's tax treaties with Colombia, Slovenia, or Lithuania will not be applicable to India's treaties with France, Netherlands, and Switzerland. Concisely, the CBDT has set out the following mandatory conditions to be fulfilled for an MFN clause to apply:

- i. The second treaty (with the third state) is entered into after the signature/entry into force (depending upon the language of the treaty) of the treaty between India and the first OECD state;
- ii. The second treaty is entered into between India and a third state which is a member of the OECD at the time of signing the treaty with it;
- iii. India limits its taxing rights in the second treaty in relation to rate or scope of taxation only in respect of relevant items of income (i.e., those items of income as set out in the MFN clause to the relevant Protocol);
- iv. A separate notification is issued by India, importing the benefits of the second treaty with the first state, as required by the provisions of Section 90(1) of the Income Tax Act, 1961 ("**ITA**").

The CBDT has also enumerated a number of reasons to substantiate its positions and the conditionalities set out.

(A) Interpretation of the MFN Clause:

While the MFN clauses to all the relevant Protocols are drafted slightly differently, the point of consistency in all the clauses is that the MFN clause applies if after the date of signing the respective tax treaty with that state, a different tax treaty is entered into "*between India and a third State which is a member of the OECD*", and which provides for a more beneficial rate or a more restricted scope. The CBDT has understood word "is" (being in present tense) to mean that the third state mandatorily needs to be an OECD member, both at the time of conclusion of India's treaty with them, and at the time of applicability of the MFN clause, for the MFN clause to be applicable. Given that Slovenia, Columbia, and Lithuania were not OECD members at the time of their respective treaties with India entering into force, the MFN clauses cannot modify the tax rates in their respective treaties (i.e., for France, Netherlands, and Switzerland).

Further, the CBDT Circular has also specified that the application of concessional rates / restricted scope as per the MFN clauses is from the date of entry into force of the tax treaty with the third state, and not from the date that the third state becomes an OECD member. The logic given is that France, Netherlands, and Switzerland (interpreting the plain language of the clause) could not have made the lower rates effective from the entry into force of the treaties with Slovenia, Lithuania, and Colombia as on those dates, because these countries were not OECD members at that point. This has been used by the CBDT to display the intention of the MFN clauses, which was not grant benefits of India's tax treaty with third states which were not OECD members at the time. Citing the Supreme Court's ruling in *Azadi Bachao Andolan*² the CBDT Circular has inferred that any interpretation to their contrary would render the language of the MFN clause redundant and lead to a manifestly absurd situation; especially when the ordinary language of the clause makes the position clear.

Indian Jurisprudence

In fact, the above was precisely argued by the Revenue before the Delhi HC in *Concentrix*³, *Nestle*⁴ and *Deccan Holdings*⁵ (all of which were ruled against the Revenue). In *Concentrix*, Delhi HC did not accept this argument, and observed that the word "is" used here describes a state of affairs that should exist not necessarily at the time when the tax treaty with the third state was executed, but only when the request is made for issuance of a lower rate withholding tax certificate. As such, the Delhi HC held that only the following conditions need to be satisfied for availing the benefit of the MFN clause:

- i. The contracting state with whom India enters into a tax treaty should be a member of the OECD (at the time benefit of the MFN clause is sought, and not necessarily when India enters into a tax treaty with such country), and
- ii. India should have, in its tax treaty executed with such contracting state, provided lower rate or limited scope in terms of the withholding tax on matters specified in the MFN clause.

Thus, the Delhi HC held that the benefit clause could be extended from the date on which a contracting state becomes member of the OECD; In observing so, the Delhi HC also recognised that there could be a hiatus period, since the Protocol provides that the benefit of MFN should be provided '*from the date on which the relevant Indian Convention or Agreement enters into force*', whereas at such time the relevant State may not be member of the OECD. As such, Delhi HC did not accept strict reading of the MFN clause by the Revenue and held that the MFN clause also covered the tax treaties whose conclusion preceded the contracting state's OECD membership date.

(B) Unilateral Directives do not represent shared understanding of treaty partners:

Considering the fact that both France and Netherlands did not respond to India's responses interpreting the MFN clause (and conducted no bilateral consultations or discussions on the same), the Circular has explicitly stated that the same cannot be understood to reflect India's views, and can have no binding force on India (so far as interpretation of the MFN clause is concerned). The Circular further states "*reliance on the mere fact that Slovenia is an OECD member State at the time of applicability of the MFN clause*" and "*not a member of the OECD when India had entered into a DTAA with it*" would "*defeat the objects and purposes of the MFN clause*", if the lower rate of taxes are imported into these treaties by virtue of the MFN clause.

In *Concentrix*, the Delhi HC specifically observed that the word "is" has both autological (a word which expresses itself) as well as heterological (a word which does not express itself) connotations; and thereby relied on the interpretation in the directive of the Dutch State Secretary of Finance as an interpretative tool to interpret the MFN clause in the India-Netherlands tax treaty. The principle of common interpretation was adopted by the Delhi HC to ensure consistency in interpretation by tax authorities and courts of the contracting states. However, as per Article 31 of the Vienna Convention on the Law of Treaties ("**VCLT**"), which is a codification of the customary laws of treaty interpretation, treaties are to be interpreted as per their ordinary meaning and in their context and light of the objects and purposes of the treaty. As per Article 32 of the VCLT, recourse may be placed on supplementary means of interpretation (such as preparatory work of a treaty, or unilateral directives, etc) only if the interpretation as per Article 31 leaves the meaning ambiguous, obscure, or leads to a result which is manifestly absurd or unreasonable.⁶ Thus, the Delhi HC's reliance on the Dutch decree, and on common interpretation does not seem to have been warranted, when the interpretation of the clause is possible from the ordinary language of the tax in light of its context, and its objects and purposes. The binding nature of value given to the Dutch decree by the Delhi HC seems to have been addressed by the Circular herein.

(C) Requirement of notification under Section 90 of the ITA:

The Circular also makes reference to the requirement of a notification in the official gazette under section 90 of the ITA, for implementation of amendments to a tax treaty. It has also been noted in the Circular that no such notification was published by India making the MFN clause operational in tax treaties with Netherlands, France or Switzerland. The Circular makes reference to *Azadi Bachao Andolan*, where the Supreme Court had observed that tax treaty provisions only come into force from the date of issuance of a notification of the said tax treaty.

The same reasoning was also argued by the Revenue before the Delhi HC in *Concentrix* decision and was rejected on the ground that the Protocol forms integral part of the tax treaty and no separate notification was required to make its provisions into effect. The Delhi HC also placed reliance on its earlier decision,⁷ where the same was observed and views of Klaus Vogel were noted that Protocol provisions completes the text of a treaty, sometimes even altering it and legally it is part of the treaty with binding force equal to that of the principal treaty text. Here too it seems that the CBDT Circular has attempted to counter the holding of the Delhi HC with respect to each of these points.

(D) No selective import of concessional rates under MFN clause:

The Circular has observed that even if MFN benefit were to be extended to tax treaties with Netherlands, France and Switzerland, then merely taking the 5% beneficial rate (which is only applicable in cases of 10% holding) was not justified, without also taking the 15% rate in all other cases. An example has also been provided, in so far as India - Lithuania tax treaty provides for a 5% tax in source jurisdiction if participation threshold of 10% is satisfied, otherwise such dividends could be taxed at 15% rate in the source jurisdiction. Whereas India's tax treaty with Netherlands, France and Switzerland provide for a maximum rate of 10% for tax of dividends in the source country. Accordingly, the Revenue has said if benefit of MFN clause in terms of 5% rate is to be incorporated (subject to participation threshold), then in other cases, 15% rate should be there instead of 10%. However, this argument of the CBDT does not appear to be as strong as the rest. The MFN clauses require for the tax treatment within their treaty to be modified such that the 'more beneficial treatment' in the second treaty is also applicable to them. If the treatment in the second treaty is not 'more beneficial', then the MFN clause cannot force the same to be imported to the first treaty.

ANALYSIS AND CONCLUSION

The Circular clarifies the stand of the Revenue i.e., benefit of the MFN clause under a tax treaty shall not be available, if preferential treatment (covered under the MFN clause) is provided in any other tax treaty where the relevant treaty partner was not an OECD member OECD at the time of entering into the tax treaty with India.

The Circular provides for a requirement of having a separate notification under section 90 of the ITA for operating the MFN clause, which seems slightly atypical. MFN clauses are intended to provide beneficial treatment to a contracting state, if such treatment is provided to other contracting states. Subjecting their applicability to a unilateral action (i.e., requirement to notify) by the contracting state (which may be at the losing end) may significantly hamper the purpose of the MFN clause. Further, the language of the MFN clause in India's tax treaty with Netherlands and France does not explicitly mention requirement of any positive act to be done by the contracting states for invoking the effect of the MFN clause i.e. it is self-operating in nature and comes into effect by itself moment India enters into a tax treaty with another OECD member. However, the Protocol to India – Switzerland tax treaty provides that (in respect of royalty / fee for technical services) if India imparts more preferential treatment to an OECD member, then Switzerland and India shall enter into negotiations without undue delay in order to provide the same treatment to Switzerland as that provided to the third state (hence it is not self-operational in nature). The Circular fails to make this distinction, and has suggested that a separate notification may be required for extending the benefit of MFN clause in case of any tax treaty.

The Circular has also clarified that it shall not impact the implementation of any court order in case of a taxpayer who has received a favourable order. As observed, the Delhi HC has already ruled in favour of taxpayers in some cases. It needs to be noted that unlike an advance ruling, decision of a High Court is binding not only on the parties involved therein, but on all subordinate courts, authorities and tribunals situated within its jurisdictional territory.

The situation as it stands today is that tax authorities of Netherlands, France and Switzerland have provided administrative guidance, and Delhi HC's (binding) decisions are in favour of taxpayers, whereas the Circular (being

an administrative guidance) is on a different note. A pragmatic approach to settle the issue is that the Revenue and tax authority of the respective country issue a joint statement clarifying the position.

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You can direct your queries or comments to the authors

¹ Circular No. 3 of 2022 dated February 3, 2022.

² 2004 10 SCC

³ Concentrix Services Netherlands B.V. vs. Income Tax Officer TDS & Anr W.P.(C) 9051/2020 and W.P.(C) 882/2021

⁴ M/S Nestle SA vs. Assessing Officer, W.P.(C) 3243/2021

⁵ Deccan Holdings B.V. vs. ITO, W.P.(C) NO. 11921 OF 2021

⁶ See also, Concentrix: A Critical Review of the Delhi High Court's Ruling on The Interpretation of the India-Netherlands Tax Treaty by Dhruv Janssen-Sanghavi, Tax Notes International, Volume 104 Number 9.

⁷ Steria (India) Ltd. vs. Commissioner of Income-tax-VI, [2016] 386 ITR 390 (Delhi)

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