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FIRST INDIAN TAX RULING ON BENEFICIAL INTERPRETATION OF MFN CLAUSE IN INDIA NETHERLANDS TAX TREATY | ALLOWS BENEFIT OF 5% TAX ON DIVIDENDS

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The Delhi High Court in its recent judgment in the case of *Concentrix Services Netherlands BV WP (C) 9051/2020 and Optum Global Solutions International BV WP (C) 882/2021 (Taxpayer)*, ruled that the 10% tax rate on dividends under the India-Netherlands tax treaty (Tax Treaty) would reduce to 5% as per the most favoured nation (MFN) clause in the Tax Treaty.

Background

Dividend received from an Indian company is taxable at 20% (plus applicable surcharge and cess) in the hands of the non-resident shareholders (and subject to withholding of applicable tax by the Indian company) subject to tax treaty benefit, if any. The Tax Treaty provides for a lower tax rate of 10% where the recipient is the beneficial owner of dividend income. However, the Tax Treaty has an MFN clause which *inter alia* provides that, if India agrees to a more beneficial tax rate (or a restricted scope) in its tax treaty with a third country which is a member of the Organisation for Economic Co-operation and Development (OECD), then such tax rate shall be applicable under the Tax Treaty as well.

Post signing of the Tax Treaty (1988), India entered into tax treaties with Slovenia (2005), Lithuania (2012) and Columbia (2014) agreeing to a tax rate of 5% on dividend income if the recipient company holds 10% or more of the share capital in the Indian company. However, these countries became OECD members post signing of their tax treaties with India, in the year 2010, 2018 and 2020 respectively.

In the instant case, the Taxpayer was a tax resident of Netherlands holding 99.99% of the share capital in the Indian company. Relying on the MFN clause read with India's tax treaties with Slovenia / Lithuania / Columbia, the Taxpayer had applied to the tax authorities to obtain a withholding tax certificate confirming the tax rate of 5%.

The tax authority however held that in the absence of any specific notification extending the benefit of the lower tax rate to the Tax Treaty, the 5% tax rate could not be applied. Accordingly, the certificate was issued confirming 10% as the applicable rate of withholding tax. Aggrieved, the Taxpayer challenged the said position by way of a writ petition before the High Court.

Tax department's objections

The main arguments of the tax authorities were:

- The benefit of the lower tax rate (or the restricted scope) agreed under India's tax treaty with another OECD member country would be applicable only if such

country was an OECD member at the time of the execution of the Tax Treaty as well as at the time of benefit being claimed by a taxpayer.

- Lithuania, Slovenia and Columbia became OECD members post signing of the Tax Treaty and execution of their own tax treaties with India. The benefit of the lower rate of tax (or a restricted scope) was extended to these countries in their own right and not because they were members of the OECD. Hence, the benefit of 5% tax rate agreed in these tax treaties cannot be provided to the Taxpayer.

- Several amendments made to the Tax Treaty were ratified by India and Netherlands and therefore, if the benefit of lower rate under India's other tax treaties is to be extended to the Tax Treaty, it can be undertaken only pursuant to a notification amending it.

High Court ruling

The High Court ruled in favour of the Taxpayer and directed the tax authorities to issue the certificate allowing the Indian company to withhold tax at 5% on the dividend income. The key factors as noted by the Court are summarised below:

- On a plain reading of the provisions of the Tax Treaty and relying on a previous decision on this issue (Steria (India) Ltd [2016] 386 ITR 390), the Court held that no separate notification is required to give effect to the lower tax rate under India's tax treaties with other OECD members, as the protocol providing for MFN clause forms an integral part of the Tax Treaty.

- The benefit of lower tax rate (or restricted scope) under India's tax treaty with a third country is to be allowed if (a) such third country is a member of the OECD and (b) the tax treaty with such third country provides for a tax rate lower or scope more restricted than the rate or scope under the Tax Treaty.

- The Court deliberated in detail on the tax department's argument that MFN clause should not apply as Slovenia / Lithuania / Columbia were neither OECD members at the time of execution of the Tax Treaty nor at the time of execution of their respective tax treaties with India. Given the language of MFN clause which reads as "*If after the signature of this convention under any Convention or Agreement between India and a third State which is a member of the OECD India should limit its taxation at source on dividend…",* the tax department's interpretation was that the third country should be an OECD member on the date of execution of the Tax Treaty.

- While the Court noted the emphasis laid by tax department on the term "is" used in the MFN clause, it held that that word "is" describes a state of affairs that exist on the date of claiming the benefit and not necessarily at the time the Tax Treaty was executed.

- To address the debate that may arise on the interpretation of the term "is", the Court considered the intent of the other treaty partner i.e. Netherlands as the best interpretative tool and referred to the decree issued by the Kingdom of Netherlands in the context of application of MFN clause. The decree *inter alia* referred to the fact that India has entered into a tax treaty with Slovenia on 17 February 2005 providing for a tax rate of 5% for dividend income (if recipient holds at least 10% of the share capital) and as Slovenia has become an OECD member on 21 July 2010, the said 5% tax rate would apply to the Tax Treaty with effect from 21 July 2010.

- The Court held that tax rate of 5% should be applicable from the date Slovenia became member of the OECD and emphasised that it's approach aligns with the

accepted principle of "Common Interpretation" of tax treaties (subject to circumstances).

- It also referred to the case of Azadi Bachao Andolan [2003] (132 Taxman 373), in which the Supreme Court observed that the core function of a tax treaty is to aid commercial relations and equitable distribution of taxes between the contracting states. Further, as the tax treaties are negotiated by diplomats and not necessarily by men instructed in the law, the rules of interpretation that apply to domestic or municipal law need not be applied.

Comment

This is a landmark ruling in the context of interpretation of MFN clause under the tax treaties and a first of its kind in India.

The ruling addresses the issue on whether the MFN clause should be interpreted to mean that the third country (with whom India has entered into a tax treaty with lower tax rate or restricted scope) has to be an OECD member on the date of execution of its tax treaty with India or the position at the time of claiming the benefit is to be evaluated.

The High Court has adopted a liberal interpretation of the relevant provisions including with respect to the date the beneficial provisions should be effective from. As per the MFN clause, the beneficial provisions should be effective from the date the other treaty with an OECD member enters into force. However, given that Slovenia was not an OECD member at the time its treaty with India entered into force, the MFN clause was not applied literally but in Court's view should be effective from the time it became an OECD member. Extent of application of "common interpretation" and the relevant point in time for testing OECD status of the other country are clearly nuanced and until there is any further clarity or a contrary decision on the issue, this ruling should set a precedent.

India has recently overhauled its dividend taxation regime. Effective 1 April 2020 tax is payable by the shareholder as against the distribution tax which was earlier payable by the distributing Indian companies with no further tax in the hands of a non-resident shareholder. Given these changes to tax law, this ruling is timely and may be beneficial not only for Dutch investors but also for investors from other jurisdictions having similar MFN clauses in their tax treaties with India such as France and Switzerland. It should be noted that every MFN clause may be worded differently and therefore, to that extent the position should be analysed on a case-to-case basis. Whether this ruling settles the debate or marks a beginning thereof is something to watch out for.

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