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INDIA TAX ADMINISTRATION CLARIFIES ITS STRICT INTERPRETATION OF THE 'MOST FAVOURED NATION' CLAUSE IN TAX TREATIES

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In a significant development, the apex tax administration body of India, the Central Board of Direct Taxes (CBDT) vide its Circular No. 3 of 2022 dated 3 February 2022 (Circular) has clarified its position with respect to interpretation of Most Favoured Nation (MFN) clauses in tax treaties. The tax treaties between India and certain jurisdictions have an MFN clause (in the protocol to those tax treaties) which captures the relevant treaty partners' understanding that if India agrees to a more beneficial tax treatment with respect to certain income streams with another treaty partner subsequently, the same should be read into the treaty having the MFN clause.

The core issue which is at the centre of the current development is whether the non-residents located in certain European countries (such as France, Netherlands, Sweden, Spain, Hungary and Switzerland) can avail the concessional tax rate of 5% on the dividends they receive from any Indian entity, by relying on the MFN clause in India's tax treaties with these jurisdictions.

Importantly, this issue was addressed by the Delhi High Court in two recent rulings (*Concentrix Services Netherlands BV WP (C) 9051/2020* and *Optum Global Solutions International BV WP (C) 882/2021*) wherein the Court held that the 10% tax rate on dividends under the India-Netherlands tax treaty would reduce to 5% as per the MFN clause in the said treaty. However, the Circular deviates from the said liberal interpretation. In this regard, the Circular does clarify that any decision rendered by any court on this issue in favour of the taxpayer will remain unaffected by this Circular.

With respect to dividend income, this issue assumed significance only from 1 April 2020 when the dividend taxation regime was overhauled (i.e. when the company level distribution tax was replaced with a shareholder level income tax). That said, the interpretational issues covered by the Circular are also relevant to other income streams which are covered by an MFN clause (like fees for services and royalty).

Background

India's tax treaties with France, Netherlands, Sweden, Spain, Hungary and Switzerland have an MFN clause which inter alia provides that, if after these treaties are signed, India agrees to a more beneficial tax rate (or a restricted scope) in its tax treaty with a third country (Third State) which is a member of the Organisation for Economic Co-operation and Development (OECD), then such beneficial tax rate (or a restricted scope) shall be applicable under the respective tax treaty as well. India's tax treaties with these jurisdictions provide for a tax rate of 10% / 15% for dividend income.

India's tax treaties with certain OECD countries like Slovenia, Lithuania, and Colombia (which were signed in 2005, 2012 and 2014 respectively) cap the tax rate on dividend income at 5% (subject to certain minimum shareholding conditions in some cases).

However, it is interesting to note that these countries became OECD members post signing of their tax treaties with India, in the year 2010, 2018 and 2020 respectively. This leads to the question regarding the date on which the OECD membership status of these countries should be tested (to benefit from the MFN clause agreed to in the other treaty) – the date the tax treaty with India was signed or entered into force; or the date on which the MFN clause is being applied; or both.

In this regard, it is pertinent to note that the decree dated 28 February 2012 issued by Directorate General for Fiscal Affairs, International Fiscal Affairs, Netherlands; bulletin of Public finance – Taxes published on 4 November 2016 by DGFIP, France; and the recent publication of the Federal Department of Finance, Swiss Confederation on 13 August 2021 had declared that the rate of tax on dividend income under their respective tax treaties with India shall reduce to 5% by invoking the MFN clause.

CBDT's clarifications

The CBDT vide its Circular has clarified its position with respect to the aforesaid interpretational issues as under:

Sr No.	Issue	CBDT's clarification
1.	Relevance of unilateral decree/bulletin/publication issued by the other jurisdictions	<p>The decree/bulletin/publication issued by other jurisdictions does not represent any mutual understanding between India and the respective jurisdiction and the same have been issued without any bilateral consultation with India.</p> <p>The interpretation laid down under the respective decree/bulletin/publication at best represents views of the respective jurisdictions and does not have any impact under the Indian tax law.</p> <p>It is also stated that India has reached out to the relevant jurisdictions to convey the aforesaid and is awaiting a response.</p>
2.	Relevant date for testing OECD membership status	The Third State (ie Slovenia, Lithuania and Columbia in the above illustration) should be an OECD member at the time of the conclusion of India's tax treaty with the Third State.
3.	Relevant date from which the benefit from the other treaty can be borrowed: (a) date of entry into force; or (b) date of Third State becoming an OECD member	The benefit will be available from the date of entry into force of the tax treaty with the Third State and not when it becomes an OECD member.
4.	Whether notification by the Indian government is mandatory for application of MFN clause	A tax treaty or any amendment to a tax treaty is effective only upon its notification in the Official Gazette as required under Section 90 of the Income-tax Act, 1961.
5.	In case a treaty with a Third State provides a beneficial	When a beneficial provision under a Third State is borrowed by invoking the MFN

	<p>provision subject to fulfilment of certain conditions, whether it is mandatory for the taxpayer to fulfil such conditions even though the benefit is being claimed under a different tax treaty by invoking the MFN clause</p>	<p>clause, the taxpayer has to import such beneficial provision along with the associated conditions and thus, selective import of a provision is not permissible.</p>
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The Circular concludes that a taxpayer is entitled to apply the MFN clause under a tax treaty (Relevant Tax Treaty) in relation to any beneficial provision under a tax treaty with the Third State only if the following conditions are cumulatively satisfied:

- The treaty with the Third State was entered into after the signing/entry into force (depending on the language in the respective tax treaty) of the Relevant Tax treaty;
- The Third State was an OECD member at the time of signing of its tax treaty with India;
- The provision in the tax treaty with the Third State is more beneficial vis-à-vis the Relevant Tax Treaty; and
- A separate notification has been issued by the Indian Government importing such benefits into the Relevant Tax Treaty.

Comments

While the Circular provides clarity on some of the important interpretational issues, it does not confirm the interpretation favourable to the taxpayers. However, it does set out the tax department's position in clear terms, which deviates from the views expressed in judicial precedents with regard to two important issues - (a) the date of OECD membership status impacting the application of the MFN clause in tax treaties; and (b) the requirement of a specific notification for applicability of a protocol to tax treaties (which includes the MFN clause).

Important to note that circulars are not binding on the taxpayers and only set out the tax department's position on a particular issue. Therefore, it remains to be seen if the non-residents and persons making payments to non-residents who are required to withhold applicable tax at source, readily accept the narrow interpretation to avoid any challenge or follow the judicially upheld principles available as on date. Another related but larger issue is whether this Circular hinders a good faith interpretation of tax treaties or aligns with it.

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