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Supreme Court ruling on Most Favored Nation Clause in Tax Treaties

The Supreme Court of India has pronounced[1] the much awaited ruling in relation to the Most Favored Nation ('MFN') clause enshrined in the protocol of certain Double Taxation Avoidance Agreements ('DTAA') which India have entered with other foreign jurisdictions[2].

Background

MFN clause requires India to extend concessions as provided under the DTAA which India subsequently enters with a jurisdiction (being an OECD member state), to other jurisdictions with which India already has a DTAA with MFN clause. Such concessions could be either for a lower rate of taxation at source or for restricted scope of certain income like royalties, fees for technical services, dividend etc.

In the past, the scope and applicability of the MFN clause has been a subject matter for multiple disputes. For example, the taxpayers have invoked the MFN clause of the India-Netherlands DTAA to avail the concessional dividend tax rate of 5% by relying upon the DTAAs of India-Slovenia and / or India-Lithuania, wherein a lower rate of 5% has been provided. This position of the taxpayers has been disputed by the Indian Revenue Authorities on the following two grounds:

- MFN clause forming part of the Protocol cannot be invoked since no separate notification has been issued by the Indian Government under Section 90(1) of the Act[3]; and
- MFN clause requires that the other jurisdiction (i.e. Slovenia/Lithuania) should be an OECD member as on the date on which Indian entered into the DTAA with such jurisdictions (i.e. Slovenia/Lithuania). However, these jurisdictions were not the OECD members when India entered the respective DTAA and have obtained the OECD membership subsequent to conclusion of the DTAAs with India.

The Central Board of Direct Taxes ('CBDT') also issued a Circular[4] wherein it prescribed conditions for conferring benefits under the MFN clause. Such conditions, *inter-alia*, states that a specific notification is required to be issued by CBDT to effectuate the Protocol of the DTAA (in relation to the MFN clause) and the jurisdiction (whose DTAA providing for beneficial provisions / tax rates) must be OECD member at the time of signing of DTAA with Indian and not later on.

However, many State High Courts have, interpreting the MFN clause, adopted a view in favour of the taxpayer by holding as under:

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1 *AO v. Nestle SA & Ors: 2023 INSC 928 (judgment dated October 19, 2023)*
2 *France, Netherlands, Switzerland*
3 *Indian Income Tax Act, 1961*
4 *Circular No. 3/2022 dated 03.02.2022*

- [5]Protocol having MFN clause appended to the DTAA does not require any separate notification,
- [6]lower rate of taxation is available by application of MFN clause, notwithstanding that the other7 jurisdiction was not a member of OECD at the time when India entered DTAA with such third jurisdiction.

The Supreme Court Ruling

The Supreme Court in its ruling has overturned both the interpretations and has held as under:

- The beneficial provisions of the MFN clause contained in the Protocol of a DTAA would not have automatic application and the same would require a separate notification under Section 90(1) of the Act notwithstanding the fact that Protocol otherwise forms part of the DTAA which has been duly notified.
- In case beneficial provisions are imported from DTAA of the other jurisdiction which was not a member of OECD at the time when India signed such DTAA, but later becomes OECD member, then, the relevant date for determining the admissibility of the MFN clause benefits will be the date when such other jurisdiction signed the DTAA with India, and not the date on which the taxpayer is claiming the benefits under the MFN.

While arriving at the above conclusions, the Supreme Court made conspectus review of various treaty provisions, international law covenants, commentaries etc. However, the key factor which weighed with the Court was that India has adopted a consistent *'practice'* of issuing separate notification(s)[8] to notify beneficial changes in the DTAA pursuant to MFN clause and therefore, due regard should be given to such uniform 'practice' while interpreting the DTAAs.

Following are some other important observations made by the Supreme Court in the ruling:

- Under the Constitution of India, there is a clear segregation of powers of Parliament and Union with respect to the international treaties. The Union has exclusive executive power to enter into international treaties and conventions, but it is the Parliament which holds the exclusive power to legislate upon such conventions or treaties. Thus, even a validly negotiated treaty duly ratified by Union does not ipso-facto acquire enforceability unless backed by Parliamentary law; which in the context of Income Tax is through issuance of notification under Section 90(1) of the Act.
- The interpretation of the word *'is'*[9] as mentioned under the MFN clause of the Protocol is of utmost importance and the same connotes a present signification. In the context, it means that other jurisdiction (the benefits of which is to be imported) should be the member of OECD at the time of entering DTAA with India.

Our Comments

- This Supreme Court ruling will have far reaching implications:
  - for Indian Revenue Authorities, it validates their stand during audits and should enable them to press on more

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5 *Refer: Apollo Tyres Ltd. v. CIT, 2017 SCC OnLine Kar 6482 (Kar.); Steria (India) Ltd. v. CIT, 386 ITR 390 (Delhi); Galderma Pharma SA v. Income Tax Officer, 2021 SCC OnLine Del 5314; Sanofi Pasteur Holding SA: 354 ITR 316 (AP)*

6 *Refer: Concentrix Services Netherlands B.V. v. ITO (TDS): W.P.(C) 9051/2020, 434 ITR 516 (Delhi); Deccan Holdings B V v. ITO: WP(C) 11921/2021; Cotecna Inspection SA: W.P.(C) 14602/2021; Nestle S.A.: W.P.(C) 3243/2021]*

7 *Some of the relevant jurisdictions are Slovenia, Lithuania and Columbia which have beneficial rate of tax on dividends*

8 *For example- the notification dated 30.08.1999 issued under India-Netherland DTAA; Notification No. S.O. 650(E), dated 10-7-2000 issued under India-France DTAA.*

9 For reference: Under India-Netherlands DTAA, following is the text in the Protocol:

*"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 dividends, interests, royalties, fees for technical services or payments for the use of equipment to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, then as from the date on which the relevant Indian Convention or Agreement enters into force the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this Convention."* [Emphasis supplied]

tax demands in cases where MFN was used for lower withholding rates etc.;
- foreign companies receiving income from India will need to revisit their tax positions;
- for the international tax community, it will provide aid for interpretation of DTAA more specifically for MFN clause.

- This Supreme Court ruling deals specifically with respect to MFN clauses under India-Netherlands DTAA, India-France DTAA and India-Switzerland DTAA. The Court has specifically de-tagged the appeal relating to MFN clause under India-Spain DTAA to be adjudicated by another bench. It will, be interesting to see whether the other bench of the Court will interpret the MFN clause (under India-Spain DTAA) differently or will it simply follow the above ratio laid down by the Court.
- Pertinently, the Court has not discussed or commented upon the Circular[10] issued by the CBDT. The Supreme Court ruling has, however, in-effect laid down similar conditions as was provided in the Circular and thus, it will be interesting to watch out the stance of the State High Courts where the validity of such CBDT circular is currently pending adjudication[11].
- The Supreme Court has held that the third country should be an OECD member at the time of signing of DTAA with India, and not the date on which the taxpayer invokes MFN clause to claim the benefits. A corollary to this interpretation, can be that even if such third country subsequently does not remain an OECD member (either due to suspension of its membership or consciously choosing to move out of the OECD), still the benefits of MFN clause can be availed by the taxpayer.
- Pursuant to this ruling, Indian Revenue Authorities may initiate tax collection measures which were earlier put in abeyance due to favorable rulings of the State High Courts. Further, where the matters are not pending under an audit, Indian Revenue Authorities may pursue reassessment, revision, rectification, miscellaneous applications etc. Therefore, there is a possibility of a spree of notices being issued by the Indian Revenue Authorities in near future.
- It will also be interesting to see whether Indian Revenue Authorities will pursue penalty proceedings against the taxpayers who had taken a view contrary to the Supreme Court ruling.

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10 Circular No. 3/2022 dated 03.02.2022

11 Refer: M/s. DXC Gatriam Holding BV: WP 6595/2022 (Kar. HC)

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