ASA
Going The Extra Mile

APPLYING MFN CLAUSE IN TAX TREATIES - INDIAN COURT PAVES WAY!

Most Favoured Nation (MFN) is a concept well known in the sphere of international tax laws. It brings parity in the tax treatment for Treaty Partner Countries. Simply put, MFN allows one Partner Country to accord with the other Partner Country, a treatment that is no less favourable than the one which it accords to other or a third country. In the context of bilateral tax treaties signed by India, the MFN clause entitles a Treaty Partner Country to avail similar benefits (concessional rate and/or restricted scope), that India has subsequently acceded to another Treaty Partner Country.

As per protocol, the MFN benefit flows inevitably to the Treaty Partner Country. In practice however, the said benefit may be denied by the revenue authorities on account of multiple reasons. In a recent judgment, the Delhi High Court1 had an occasion to examine the applicability of MFN clause with respect to the India-Netherlands Tax Treaty. We have summarised the key principles emanating from this judgment.

Facts in Brief

The taxpayer, a resident of Netherlands, had a wholly owned subsidiary in India. During the fiscal year 2020-21, its Indian subsidiary proposed to distribute dividend. With abolishment of Dividend Distribution Tax (DDT), the dividend was taxable in the hands of recipient taxpayer. Thus, the taxpayer sought lower tax deduction by way of an application under section 197 of the Income-tax Act, 1961 (Act).

In support of the application, the taxpayer contended it was entitled to MFN benefits as per treaty protocol and accordingly, a concessional tax rate of 5% should apply as against 10% under the India-Netherlands tax treaty. The Tax Officer rejected this claim stating that that the MFN benefits could not be extended to India-Netherland's treaty in absence of a specific notification to this effect. Aggrieved, the taxpayer moved a writ petition before the Delhi High Court.

Decision of the Delhi High Court

The Hon'ble Court endorsed the taxpayer's entitlement to concessional rate at 5% as per the MFN clause and accordingly directed the revenue authorities to issue a fresh certificate. The Court observed that -

- As per Article 10 of the treaty, the dividend paid to Netherlands company may be taxed in India at a rate not exceeding 10% of the gross dividend, provided the recipients are beneficial owners of such dividend.
- The protocol forms an integral part of the tax treaties. Therefore, no separate notification is necessary to enforce the applicability of provisions under the protocol. Reliance was placed on the division bench's decision in case of Steria (India) Ltd2.
- The protocol incorporates the principle of parity between the India-Netherlands treaty and the tax treaties executed thereafter, qua the rate of withholding tax or the scope of the tax treaties, in respect of incomes concerning dividends, interest, royalties, fees for technical services or payments for use of equipment. This parity kicks-in only when
  - the third State with whom India enters into a tax treaty is an OECD member.
  - India should have, in its tax treaty executed with the third state, limit its rate of withholding tax on subject remittances to a rate lower, or a scope more restricted than the scope provided in subject tax treaty.

Upon satisfaction of the aforesaid conditions, the same rate of withholding tax or scope as provided in the tax treaties executed between India and third state would apply to the subject tax treaty. The same rate or scope shall be applicable from the date on which the tax treaty between India and third state comes into force. Therefore, the argument of revenue authorities that the beneficial provisions contained in the tax treaties, executed prior to or after the coming into force of the India-Netherlands Tax Treaty, could not apply to recipients of remittances covered under the India-Netherlands tax treaty, despite the concerned third state being an OECD member, is misconceived and contrary to the plain terms of the protocol appended to the subject tax treaty.

- The construct of treaty protocol is such that in certain cases, there could be an interval between the dates on which the tax treaty is executed between India and the third state, and the date when such third state becomes an OECD member. In such cases, the MFN benefit can only apply when the third state acquires OECD membership. This condition should be satisfied at the time of issuance of lower rate of withholding tax.
- The High Court emphasized that the principle of common interpretation should apply uniformly to ensure consistency and equal allocation of tax claims between the Contracting States. Reference was made to the landmark decision of Azadi Bachao Andolan3, wherein the Apex Court has observed that the core function of a tax treaty is to aid commercial relations and equitable distribution of taxes between the Treaty Partner Countries. Hence, any discretionary interpretation can dilute the international tax principles which are stemmed on equitable distribution of taxing rights between the Treaty Partner Countries.

  Following this judgment, the Hon'ble Court has extended similar benefit of lower tax withholding on payment of dividend at 5% under the Indo-Swiss Tax Treaty in the case of Nestle.4

Key Takeaways from the High Court Decision

- This is a landmark judgement in the context of interpretation and applicability of MFN clause under the tax treaties and first of its kind in India. While the application of the MFN clause is a known concept, this issue has been intensified with the re-introduction of the classical system of dividend taxation.
- With abolition of the DDT regime, dividend is now taxable in the hands of shareholder. The guidance in this judgement will help non-resident shareholders to evaluate the applicability of MFN clause existing in the treaty between India and their country of residence. If so, a shareholder may consider applying for the concessional rate mentioned in other tax treaties that were executed subsequently.
- It is worth a mention that the MFN clauses extends to other streams of income, namely interest, royalties and fees for technical services, and hence the taxpayers would have an opportunity to evaluate the impact of this favorable ruling in respect of taxability of such other streams of income in accordance with a clear understanding of the MFN clause.
- The ratio of this judgment will not only benefit Dutch investors, as equally investors from other jurisdictions such as France, Sweden, Spain, Hungary, etc., having similar MFN clauses in their respective tax treaties with India. However, prior to taking a position, it is advisable that the MFN clause is examined in light of the facts of each case. While applying the MFN clause, taxpayers need to be cautious with respect to the beneficial ownership criteria, if provided. Besides, India's ratification of Multilateral Instruments (MLI) can also impact the MFN clause.
- While this judgment squarely favours the taxpayer, it would be interesting to see the continued position taken by the revenue authorities on the issue of tax withholding on dividend income, etc., w.r.t non-resident taxpayers. Will they accept or continue to challenge the contextual interpretation by the High Court?
- From a compliance standpoint, it would be critical to make the correct disclosures in Form 15CB or in the TDS return filed by the payer/ deductor. It is likely that the Centralized Processing Centre may process the TDS returns considering the actual tax treaty rate without allowing benefits under the MFN clause.

[1]Concentrix Services Netherlands BV vs ITO (TDS) and ANR [WP(C) 9051/2020], and Optum Global Solutions International BV vs DCIT and ANR [WP(C) 882/2021, CM Appl. 2302/2021]

[2]Steria (India) Ltd vs. CIT-VI [2016] 386 ITR 390 (Delhi High Court)

[3]Union of India and Anr vs. Azadi Bachao Andolan [2004] 10 SCC 1 (Supreme Court)

[4]Nestle SA vs. Assessing Officer Circle (International Taxation)- 2(2)(2), New Delhi, [WP(C) 3243/2021]

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