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TAX FLASH NEWS

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Tax is to be deducted at a concessional rate of 5 per cent on dividends in view of the MFN clause under the India-Netherlands tax treaty

Executive Summary

Recently, the Delhi High Court in the case of Concentrix Services Netherlands BV and Optum Global Solutions International BV[1] (taxpayers) dealt with the issue of eligibility of lower rate of tax on payment of dividend in view of the Most Favoured Nation (MFN) clause contained in the protocol to the India-Netherlands tax treaty. The High Court held that lower tax rate at 5 per cent on dividend provided in the subsequent Indian tax treaties with Slovenia, Colombia and Lithuania would apply in view of the MFN clause under the India-Netherlands tax treaty (tax treaty).

The High Court referred to the decree issued by the Kingdom of Netherlands which was published on 13 March 2012. The Netherlands interpreted the protocol to the tax treaty in a manner that the lower rate of tax in the India-Slovenia tax treaty will be applicable on the date when Slovenia became a member of the OECD, i.e., from 21 July 2010[2], although, such tax treaty came into force on 17 February 2005.

Facts of the case

The taxpayers were resident of the Netherlands holding 99.99 per cent share in their Indian counterparts (i.e. Concentrix India and Optum India respectively). In 2020, both the taxpayers, had applied for lower deduction certificate on receipt of dividend under Section 197 of the Income-tax Act, 1961 (the Act) in view of MFN clause under the tax treaty. The Assessing Officer (AO) rejected the request of the taxpayers for deduction of tax at the concessional rate of 5 per cent under the tax treaty read with protocol thereto and directed that withholding tax rate of 10 per cent was applicable. The taxpayers filed a writ petitions before the Delhi High Court.

High Court decision

The dividend provisions under the tax treaty are relevant to determine as to what would be the withholding tax rate applicable qua dividends. Article 10 of the tax treaty provides that dividends can be taxed in India provided the recipients are beneficial owners of the dividends and the tax rate does not exceed 10 per cent of the gross amount of such dividends.

A perusal of the protocol to the tax treaty indicates that the protocol forms an integral part of the tax treaty. Therefore, no separate notification was required, insofar as the applicability of provisions of the protocol is concerned. The High Court relied on the decision of Steria (India) Ltd[3]. The protocol incorporates the principle of parity between the subject tax treaty and the tax treaties executed thereafter qua the rate of withholding tax or the scope of the tax treaties in respect of items of income concerning dividends, interest, royalties, FTS or payments for use of equipment.

Therefore, the argument advanced on behalf of the tax department, that the beneficial provisions contained in the tax treaties, executed both prior to or after the coming into force of the tax treaty, i.e., 21 January 1989, could not be made applicable to the recipients of remittances covered under the subject tax treaty even though the concerned third State was a member of the OECD is, completely misconceived and contrary to the plain terms of the protocol appended to the subject tax treaty.

In certain cases, there could be a hiatus between the dates on which the tax treaty is executed between India and the third State and the date when such third State becomes a member of OECD. The limit on the lower rate of tax or the scope more restricted contained in the tax treaty executed between India and the third State can only apply when the third State fulfils the attribute of being a member of the OECD. The word 'is' provided in MFN clause of the tax treaty describes a state of affairs that should exist not necessarily at the time

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[1] Concentrix Services Netherlands BV v. ITO (W.P.(C) 9051/2020) and Optum Global Solutions International BV v. DCIT (W.P.(C) 882/2021) – Taxsutra.com

[2] It has been mentioned in the Delhi High Court decision that Slovenia became a member of OECD on 21 August 2010. However, as per the decree issued by the Netherlands and the OECD website, Slovenia became a member of OECD on 21 July 2010.

[3] Steria (India) Ltd. v. CIT [2016] 386 ITR 390 (Del)

when the subject tax treaty was executed but when a request is made by the taxpayer or deductee for issuance of a lower rate withholding tax certificate under Section 197.

Reference is made to the decree issued by the Kingdom of Netherlands which was published on 13 March 2012. The Netherlands interpreted the protocol appended to the tax treaty in a manner that the lower rate of tax in the India-Slovenia tax treaty will be applicable on the date when Slovenia became a member of the OECD, i.e., from 21 July 2010, although, such tax treaty came into force on 17 February 2005. Therefore, participation dividend paid by companies' resident in the Netherlands to a resident in India will bear a lower withholding tax rate of 5 per cent.

The purpose of entering into the tax treaties is the equitable allocation of taxes concerning transactions that are taxable in both States. The High Court's approach aligns with the accepted principle applied in the interpretation of the tax treaties. This is the principle of 'Common Interpretation'. The Courts of the contracting States are, thus, required to ensure that tax treaties are applied efficiently and fairly so that there is consistency in the interpretation of the provisions by the tax authority and courts of the concerned contracting State.

Where the other contracting State, i.e., the Netherlands has interpreted the Protocol in a particular way, in the fitness of things, the principle of common interpretation should apply on all fours to ensure consistency and equal allocation of tax claims between the contracting States. Thus, the High Court is not impressed with the argument of the tax department that since Slovenia, Lithuania, and Columbia became members of the OECD, not only after the tax treaty came into force but also after their own tax treaty came into force, and therefore, lower rate of withholding tax on dividends would not apply to recipients in the Netherlands.

Reference may be made to the decision of the Supreme Court in the case of Azadi Bachao Andolan and Another[4]. A perusal of the Supreme Court's observations indicates that while interpreting tax treaties, the rules of interpretation that apply to domestic or municipal law need not be applied, for the reason, that international treaties, conventions and tax treaties are negotiated by diplomats and not necessarily by men instructed in the law. Therefore, their interpretation is liberated from the technical rules which govern the interpretation of domestic/municipal law. The core function of a tax treaty should be seen to aid commercial relations and equitable distribution of tax revenues in respect of income which falls for taxation in both the deductor and the deductee States, i.e., the contracting States.

Accordingly, the lower deduction certificates issued by the AO requiring a deduction at the rate of 10 per cent instead of 5 per cent deserve to be quashed. The High Court held that the AO shall issue a fresh certificate under Section 197 to provide withholding tax rate of 5 per cent.

Our comments

This is a welcome decision by the Delhi Court awarding benefit of lower tax rate on dividend payments available in subsequent Indian tax treaties in view of MFN clause in the India-Netherlands tax treaty. In this decision, the High Court has dealt with the issue of applicability of MFN clause in detail.

The Delhi High court in the instant case has upheld the protocol forms an integral part of the tax treaty. Thus, no separate notification is required, for the applicability of the provisions of the protocol. The High Court had given similar kind of observations in its earlier decision while analysing the India-France tax treaty in the case of Steria (India) Ltd.

It may be noted that the High Court has followed the interpretation adopted by the Netherlands in the decree issued by it. The Netherlands had interpreted that the lower rate of tax in the India-Slovenia tax treaty will be applicable on the date when Slovenia became a member of the OECD i.e. from 21 July 2010, although, the tax treaty came into force on 17 February 2005. The High Court seems to have adopted this approach to maintain consistency in the interpretation of the provisions by the tax authority and courts of the concerned contracting State.

The High Court on a perusal of the language of the MFN clause under the India-Netherlands tax treaty rejected revenue's argument that Slovenia, Lithuania, and Columbia became members of the OECD, not only after the Netherlands tax treaty came into force but also after their own tax treaty came into force, and therefore, lower rate of withholding tax on dividends would not apply to recipients in the Netherlands. It is worthwhile to note that wherever required the tax treaties provide clear language that the subsequent tax treaty should be the member of OECD at the specified time to avail the benefit of MFN clause for example Switzerland has entered into a tax treaty with Kazakhstan having an MFN clause which requires a third country to be an OECD member at a given point of time i.e. the MFN benefit is available only if Kazakhstan after 15 December 1998 has signed a convention for the avoidance of double taxation with a present member state of OECD which provides for a lower effective rate on interest or on royalties.

Based on an in-depth analysis of the MFN clause given by the High Court, taxpayers may evaluate their dividend transactions with the Netherlands based entities and may opt for the benefit of lower withholding tax at the rate of 5 per cent available under India's tax treaties with Slovenia, Lithuania and Columbia.

However, it is also important to note that India's tax treaties with Slovenia and Lithuania provide for a tax rate of 5 per cent on dividends only if a shareholder is holding at least 10 per cent of the capital of the company paying the dividends. Whereas the India-Colombia tax treaty does not provide for any such condition to avail the 5 per cent tax rate.

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[4] UOI v. Azadi Bachao Andolan and Another (2004) 10 SCC 1

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