

TAX FLASH NEWS

7 February 2022

CBDT issues clarification on applicability of MFN clause in certain tax treaties

Executive Summary

Several Indian tax treaties provide for the Most Favoured Nation (MFN) clause, whereby source-based taxation of dividend, interest, royalties, Fees for Technical Services (FTS), etc. can be further restricted if India extends a more beneficial treatment to another country in a subsequent tax treaty.

The Central Board of Direct Taxes (CBDT) received representations on the applicability of MFN clause (particularly to dividend withholding rates) to some of the tax treaties with OECD member states, specifically in the context of unilateral positions taken by the Netherlands, France and Switzerland on availability of MFN clause in their tax treaty with India.

The CBDT has issued a circular¹, which provides that the MFN clause can be invoked only when all the following conditions are met:

- India subsequently enters into a treaty with a third state;
- The subsequent treaty is entered into between India and a state which is a member of the OECD at the time of signing the treaty;
- The subsequent treaty provided for a lower rate or restricted scope of taxation; and
- India has issued a notification permitting invocation of MFN clause on account of beneficial treatment accorded in the subsequent treaty.

CBDT Circular

The third state should be a member of the OECD on the date of the conclusion of the tax treaty

- The Netherlands had issued a unilateral decree that the tax rate on dividend under their tax treaty with India stands modified under the MFN clause due to the lower rate provided in the tax treaty with Slovenia, which became a member of OECD on 21 July 2010. A similar position was taken by France and Switzerland in relation to their tax treaties with India.
- The CBDT has clarified that MFN clauses in India's tax treaties, especially with respect to the above-mentioned countries, requires the third state is to be a member of the OECD both at the time of conclusion of the treaty with India as well as at the time of applicability of the MFN clause. If a treaty partner becomes a member of OECD subsequently, it should not trigger MFN clauses in other tax treaties with India. For instance, a tax treaty with Slovenia was entered by India in 2005 while it became a member of OECD in 2010. Since Slovenia was not a member of OECD at the time of entering into a treaty with India, a lower rate in the India-Slovenia tax treaty should not trigger the MFN clause in other tax treaties.

Application of concessional rates/restricted scope from the date of entry into force of the tax treaty with the third state and not from the date the third state becomes a member of the OECD

- MFN clause in these tax treaties clearly states that the reduced rate takes effect from the date of entry

¹ CBDT Circular No. 3/2022, dated 3 February 2022

into force of the Indian tax treaty with the third State. Thus, the position taken by the Netherlands, France and Switzerland to apply the reduced rate from the date of the third state becoming a member of OECD subsequent to the entry into force of a tax treaty is not in accordance with the relevant position of the MFN clause in the protocol.

- In fact, these countries could not have made it effective from the date of entry into force of India tax treaty with the third state as the third state was not a member of the OECD on such date of entry into force. This makes it clear that the intention of the MFN clause in the protocol of the tax treaty is not to give the benefit of India's tax treaty with the third state which was not a member state of OECD when India entered into a tax treaty with it.

Requirement of notification under Section 90 of the Income-tax Act, 1961

- The CBDT clarified that the tax treaty or an amendment to it could be implemented only after its notification in the Official Gazette in India. India has not issued any notification importing the benefit of treaties with Slovenia, Lithuania and Colombia to treaties with the Netherlands, France or Switzerland. Hence, the MFN clause cannot be invoked on Income sourced from India unless the Indian government issues a specific notification.

No selective import of concessional rates under MFN clause

- India's treaties with Slovenia and Lithuania consist of a split rate of tax for dividends². For instance, Article 10(2) of the India-Lithuania tax treaty provides for a 5 per cent tax on dividend if the company (other than a partnership) receiving the dividends holds directly at least 10 per cent of the capital of the company paying the dividends. Other dividends are to be taxed at the rate of 15 per cent.
- The tax authorities of the Netherlands, France and Switzerland have taken into account the rate of 5 per cent on holding of 10 per cent ownership through the MFN clause without switching to a 15 per cent tax rate in other cases. India has expressed its concerns on this position to these countries, which still has remained unaddressed.

Unilateral decree/bulletin/publication does not represent shared understanding of the treaty partners on the applicability of the MFN clause

- The Netherlands and France have passed the

decree/published bulletin without having any bilateral consultation with India. Therefore, this decree/bulletin does not represent the shared understanding of India and the respective treaty partners. At best, this is the view of the respective governments for providing relief from the Netherlands/France tax and would not have any effect on curtailing the taxing rights of India.

- In the case of Switzerland, India has communicated its position that the benefits of India's tax treaty with the third state cannot be imported into the India-Switzerland tax treaty unless the third state was a member of the OECD at the time of signing that treaty.

Impact on existing rulings in India

The Circular has clarified that where in the case of a taxpayer there is any decision by any court on this issue favourable to such taxpayer, this Circular will not affect the implementation of the court order in such case.

Our comments

The Delhi High Court in the case of Concentrix Services Netherlands B.V.³ granted the benefit of the lower rate of dividend invoking MFN clause through India-Slovenia tax treaty with effect from the date Slovenia became a member of the OECD, i.e., from 21 July 2010. The court held that the requirement of the state to be a member of OECD should exist not necessarily be at the time when the subject tax treaty was executed but when the benefit of MFN needs to be invoked⁴. Further, the court relying on its earlier judgment in the case of Steria (India) Ltd.⁵ (rendered in the context of India-France tax treaty) also held that there is no requirement of notification in order to trigger the MFN clause in the India-Netherlands tax treaty. The position taken by the CBDT in the Circular is contrary to the High Court decisions. Hence, one would have to wait for the Apex Court to finally settle this dispute.

The Circular has been issued in the background of positions taken by the Netherlands, France and Switzerland on invocation of MFN clause through subsequent tax treaties where the country has become an OECD member after entering of the treaty with India. However, the mandatory requirement of notification for MFN clause to become operative may have a bearing on other situations as well. Thus, it is incumbent on the CBDT to proactively notify the availability MFN clause across its treaty network.

² Article 10(2) of the Indian-Lithuania treaty provides two rates
a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
b) 15 per cent of the gross amount of the dividends in all other cases.

³ Concentrix Services Netherlands B.V. v. ITO (W.P.(C) 9051/2020)

⁴ This position was followed in the context of the India-Switzerland tax treaty in the case of Nestle SA v. Assessing Officer Circle (W.P.(C) 3243/2021).

⁵ [2016] 386 ITR 390 (Delhi)

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