



Tax Flash News

21 October 2023

The benefit of MFN clause under the Indian tax treaties can be availed only after the Indian government issues a notification for the same – the Supreme Court

Indian tax treaties with some of the countries like the Netherlands, France, Switzerland, Hungary, Sweden, etc. have a Most Favored Nation (MFN) clause. The MFN clause in these treaties extends benefit of a lower rate or restricted scope with respect to certain specified incomes such as, interest, dividend, royalty, fees for technical services, if after the signature/entry into force of the treaty containing MFN clause, India enters into a treaty with an Organisation for Economic Cooperation and Development (OECD) member state and provides therein a lower rate or restricted scope.

In this regard, an issue arose, whether the benefit of lower rate or restricted scope under MFN clause can be applied automatically or it will come into effect after a notification is issued by Indian government. Further, when should the condition of the third state being an OECD member be fulfilled, at the time of application of the MFN clause or at the time when India had signed the treaty with the third state. These issues have been dealt with by various Courts/Tribunal and finally the matter reached before the Supreme Court.

The Supreme Court in the case of Nestle SA¹ held that a Notification under Section 90 of the Income-tax Act, 1961 (the Act) is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a tax treaty, or any protocol changing its terms or conditions, which has the effect of altering the existing provisions of law. Further, the Supreme Court held that a beneficial treatment given under a subsequent treaty with a country which is not an OECD member on the date of entering into the treaty but subsequently becomes an OECD member cannot be claimed under MFN clause.

The dispute

- The High Courts in various decisions held that the MFN clause is to be given effect to automatically and does not require a separate notification. Also, the High Court held that there is a right to invoke the MFN clause vis-à-vis a third country with which India has entered into a tax treaty which was not an OECD member at the time of entering into such tax treaty but subsequently becomes an OECD member.
- The tax department challenged the High Court's decisions involving the interpretation of MFN clause contained in various Indian treaties before the Supreme Court. The Indian treaties in question were Netherlands, France, and Switzerland. Foreign companies sought to invoke the beneficial rate of 5% on dividend income under the MFN clause vis-à-vis the tax treaties with Slovenia, Lithuania and Columbia which became OECD members subsequent to entering into treaties with India.
- The tax department mainly contended that even though the conditions set out in the MFN clause were satisfied, the benefit could not be availed unless there was a specific notification by the government of India effectuating the benefit under the MFN clause. Further, the MFN clause requires that the other country is required to be an OECD member as on the date of the signing of the treaty and not on any future date.

¹ AO (International taxation) v. Nestle SA (Civil Appeal Nos. 1420 to 1432 of 2023) (SC) - Taxsutra

Supreme Court's decision

A notification is required to avail the benefit of MFN clause

- The terms of a treaty ratified by the Union of India do not ipso facto acquire enforceability. While the Union has the exclusive executive power to enter into international treaties and conventions under Article 73 of the Constitution of India, the Parliament holds the exclusive power to legislate upon such conventions or treaties.
- In India, either the treaty concerned has to be legislatively embodied in law, through a separate statute, or get assimilated through a legislative device, i.e., notification in the gazette. Absent this step, treaties, and protocols are per se unenforceable.
- In case of Indian tax treaties with the Netherlands, France and Switzerland, to avail benefit of MFN clause, separate notifications were issued post entering into beneficial tax treaties with OECD member countries. The above notifications reinforced India's practice and conduct of giving the effect of the subsequent event of a more beneficial arrangement with a third country, to the original treaty country, on the basis of Notification. In each of the above-discussed three countries, every treaty entered into by the executive government needs ratification.
- Whilst considering treaty interpretations, it is vital to take into account practice of the parties. The role of practice, not bilateral or joint practice but practice by one is accepted generally by the international community, which is relevant and at times determinative.
- Upon India entering into a treaty or protocol, it does not result in its automatic enforceability in courts and tribunal. The provisions of such treaties and protocols do not, therefore, confer rights upon parties, till such time, as appropriate notifications are issued.
- Notification is a mandatory condition to give effect to treaty or protocol changing its terms or conditions which has the effect of altering the existing provisions of law.

Relevant date for OECD member test

- The wordings under the MFN clauses are – 'that the subsequent country is a member of OECD'. The High Courts have interpreted that the term 'is' describes a state of affairs that should exist not necessarily at the time when the treaty was executed but at the time when benefit under the MFN clause is claimed.
- The Supreme Court observed that the term 'is' has a present signification, and it derives meaning from the context. Therefore, to claim a beneficial treatment given under a subsequent treaty with an OECD member state, the relevant date is the date of entering into such tax treaty and not a when such country becomes an OECD member at a later date.

Our comments

The Supreme Court decision would now impact the practice of claims made by taxpayers under MFN clauses in tax treaties that India has signed with other countries. In particular, foreign companies would need to ensure that the benefit from the MFN clauses have been specifically notified by India before seeking to avail them. Also, from this decision, it is clear that MFN benefit can only be availed of by taxpayers in respect of subsequent treaties entered into by India with an existing OECD member country (and not vis-à-vis a country that become OECD members subsequent to signing their tax treaty with India). This would significantly restrict the scope of benefits claimed by foreign companies under MFN clauses, for example, relating to taxation of dividend income received from India. Following this Supreme Court's decision, it would also be of interest to taxpayers to see if the Indian Government would issue notifications for taxpayers to take benefit of MFN clauses (preferably with retrospective effect) for tax treaties that have been signed by India previously, for example, with France where the restricted scope for "fees for technical services" clause has not been specifically notified, even though there exists no legal dispute around its eligibility under the relevant MFN clause.

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