dhruva

Corporate Tax Alert

October 26, 2023

Supreme Court rules on automatic enforcement of Most Favoured Nation clause in Indian Tax Treaties

In a recent significant ruling[1], the Hon'ble Supreme Court has held that availing any benefit on basis of the Most Favoured Nation ('MFN') clause under Double Taxation Avoidance Agreement ('DTAA') is not automatic, and a specific Notification under Section 90(1) of the Income-tax Act, 1961 ('the Act') is a mandatory requirement. On the aspect of claiming "same treatment" benefit by invoking the MFN clause in a DTAA between India and other state, based on subsequent entry of another DTAA between India and third state which is a member of the Organisation for Economic Cooperation and Development ('OECD'), it is clarified that such third state should be a member of the OECD at the time of entering into the DTAA with India (and it is not sufficient for such third state to become an OECD member after entering into the DTAA with India).

Background and facts of the case

- In some DTAAs entered by India with various countries, e.g., the Netherlands, France and Switzerland, an MFN clause has been agreed upon by the Union of India with their respective counterparts.
- The MFN clause *inter-alia* broadly provides that if after signing of the first DTAA, India signs a DTAA with any other country which is an OECD member, and such later DTAA provides a restricted scope for taxation or lower rate of tax qua different categories of income to the tax resident of the other

[1] Nestle SA [TS-616-SC-2023] and other cases clubbed together.

© Copyright Dhruva Advisors LLP.

country, then the restricted scope of taxation or lower rate of tax will also be offered under the first DTAA. Such clauses are usually entered to ensure equal treatment to the OECD members without there being a need for independent negotiation which is a time-consuming process.

- India had signed DTAA with Columbia, Slovenia, Lithuania at different points in time. After signing the DTAA with these countries, each of them became members of the OECD again at different points in time. As a result of favourable treatment offered in respect of certain incomes in these DTAAs, there was trigger for invoking the MFN clauses existing under the earlier DTAA that India had signed with the OECD member countries.
- The aforesaid case dealt with the following two aspects:
  - Whether the benefit pursuant to the MFN clause in a DTAA applies automatically once there is trigger basis signing of a favourable DTAA with another state, or whether a separate notification is required to be issued under Section 90(1) of the Act for such benefit to become applicable?
  - Whether the MFN clause can be invoked when the third country, with which India entered into DTAA, was not an OECD member at the time of entering into such DTAA?
- Various High Courts had given a favourable verdict, and the tax department was in appeal before the Supreme Court. The relevant facts pertaining to impugned judgements of High Courts which were up for consideration before the Supreme Court are briefly mentioned hereunder:

1) Nestle SA[2] and Concentrix Services Netherlands BV and Optum Global Solutions International BV[3]

After the abolishment of Dividend Distribution Tax ('DDT'), taxpayers who were residents of the Netherlands/ Switzerland sought for lower withholding tax at the rate of 5% on payment of dividends. The taxpayers put forth a proposition that the benefit under the MFN clause under respective DTAAs with India enables to import the aforesaid lower tax rate as per subsequent DTAAs[4] entered into by India and third countries which are members of the OECD as on the date of applying the MFN clause (though such third countries were not OECD member at the respective time of entering into the DTAA, with India).

2) Steria India Limited[5]

The taxpayer, on basis of the MFN clause under the Protocol to the India-France DTAA, imported in the India-France DTAA the restricted definition (i.e., with 'make available' clause) of 'fees for technical services' ('FTS') as provided in the subsequently entered India-UK DTAA. It was challenged that such automatic adoption of a restrictive definition of FTS from the India-UK DTAA into the India-France DTAA pursuant to MFN clause existing in India-France DTAA is not possible unless there is a Notification issued u/s. 90 of the Act to grant such benefit under the India-France DTAA.

[2] Nestle SA [TS-446-HC-2021(DEL)]

[3] Concentrix Services & Optum Global's case [TS-286-HC-2021(DEL)],

[4] E.g. Columbia, Slovenia, Lithuania

[5] Steria [TS-416-HC-2016(DEL)]

© Copyright Dhruva Advisors LLP.

- Hon'ble High Courts in each of the above referred cases, had ruled in favour of the taxpayers. Aggrieved by these rulings, the Revenue filed appeals before the Supreme Court against these High Court Rulings.

Revenue's key arguments

- The constitutional framework of India states that entering into a DTAA is different from implementing the DTAA. A treaty becomes law only when enabled by parliamentary legislation[6].
- India has adopted the "dualist" practise, which means that treaties need to be "transformed" into domestic law by an act of national law to become internally binding. This contrasts with practice by certain other countries wherein international treaties do not require any domestic act of law to become binding domestically if they are self-executing in character.
- The treaty practice of India makes it necessary to issue a separate notification under Section 90 of the Act, to give effect to the MFN clause in India's DTAA with the first country, pursuant to a more beneficial DTAA of India with a third country.
- In many cases, the amending notification granted one benefit (e.g., a lower tax rate) while denying/ not extending other benefits (e.g., restrictive scope) of the MFN clause of respective DTAAs. This clearly shows that such notifications were necessary and there could not be any automatic applicability of all benefits under the MFN clause to taxpayers of counterpart countries.
- The MFN clause evidently indicates that the third country is required to be an OECD member as on the date of the signing of DTAA with such third country and not on any future date. Thus, when Slovenia, Lithuania, or Columbia entered into respective DTAAs with India, they had to have been members of the OECD at that time, for the Netherlands, France, and Switzerland to claim parity of treatment pursuant to MFN clause in their respective DTAA with India.

Taxpayer's key arguments

- Respective DTAAs along with their Protocols (having the MFN clause) were already notified under Section 90(1) of the Act. Once the aforesaid DTAAs with their protocols have been notified and had come into force, there is no further legal requirement to notify any subsequent amendment to the DTAAs if the MFN clause (granting 'same treatment') operates *automatically*.
- Whether the MFN clause in any DTAA triggers automatically or requires bilateral negotiations/ further notifications would depend upon the language of the respective MFN clause itself.
- The MFN clauses in certain DTAAs/ Protocols[7] specifically require respective countries to enter into bilateral negotiations/ or to notify such beneficial provisions, with a view to extend the beneficial MFN provisions. However, the relevant MFN clauses/ language of the DTAAs with the Netherlands, France, Switzerland[8] has no such requirements and, consequently, should operate automatically whenever the MFN clause is triggered[9], without any further

---

[6] Article 253

[7] E.g. DTAA of India with foreign countries like Philippines, Finland, Switzerland etc,

[8] To the extent of granting lower rate of tax

[9] 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

© Copyright Dhruva Advisors LLP.

notification. The use of different language in a DTAA is indicative of the intent of two countries and cannot be disregarded while interpreting their terms.

- India's practice qua certain DTAAs of issuing a notification[10] to give effect only to certain beneficial provisions of the MFN clause of the respective DTAA is unilateral in nature and could not be regarded as a bilateral amendment by states. The absence of a unilateral notification which may have in the past been issued as an administrative practice cannot override the clear language of an MFN clause which provides for automatic application.
- Various countries with whom India had signed such DTAA with the MFN clauses, had issued executive orders / decrees[11] accepting the favourable treatment under such subsequent DTAA reflecting the understanding of the treaty partner with regard to the extension of benefit under the MFN clause of the respective DTAA.
- With regard to the DTAAs with countries which became members of the OECD subsequent to the signing of the respective DTAAs, it was contended that the word "is" used in the sentence "which is a member of the OECD" in context of the MFN clause stipulates that a country must be an OECD member when the MFN clause is sought to be applied and not at the time when the original DTAA was executed.

Supreme Court ruling

- The Supreme Court after thorough examination concluded the following three principles:
  - Notification under section 90(1) of the Act is necessary and a mandatory condition to give effect to a DTAA, or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of law (*irrespective of the language* used *in the said DTAA/ Protocol*).
  - The beneficial treatment contained in a DTAA with a third country (which is a member of the OECD) will not automatically be imported in the earlier DTAA, entered into by India with the first country which has an MFN clause. In such a case, the earlier DTAA is to be amended, post communication/ negotiation with other country, through a separate notification, to give effect to the MFN clause.
  - The interpretation of the expression "is" has present signification. Therefore, the third country should be a member of the OECD when it enters into a DTAA with India and not at a later date.
- While coming to the above conclusions, the Supreme Court briefly made the following observations:
  - As per the Indian Constitution, Parliament has the exclusive power to legislate in respect of any treaty or convention, entered into by India, with any other nation.
  - Indian jurisprudence sheds light on the fact that the treaty terms ratified by the Union do not ipso facto acquire enforceability but require independent legislation by the parliament. Effectively pointing towards the Parliament's

[10] E.g., Notification 30 August 1999 notifying certain beneficial provisions of MFN clause in Protocol to India-Netherland DTAA

[11] E.g., the Netherlands, Switzerland, France etc.

© Copyright Dhruva Advisors LLP.

exclusive power to legislate upon such conventions or treaties.

- Thus, India entering into a DTAA or Protocol does not result in its automatic enforceability. The provisions of such DTAAs/ Protocols having MFN clauses do not therefore, confer rights upon parties, till such time, as appropriate notifications are issued, in terms of Section 90(1) of the Act upon there being triggering events for applying the MFN clause.

- The Supreme Court observed that it has been consistent practice of India to issue Notification(s), once the MFN clause is triggered in respective DTAAs, for granting specific 'same treatment' benefit (e.g., rate reduction/ date of applicability of reduced rates, relief on scope etc.). It has been carefully pointed out that such notifications issued, have not and also need not cover all the benefits provided under the Protocol, upon the trigger due to a subsequent favourable DTAA.

- Reliance was placed on various international conventions/ commentaries/ jurisprudence which *interalia* recognize that subsequent practice, being objective evidence of understanding of the parties, are authentic means of interpretation of treaties. The Court held that while considering treaty interpretation, it is vital to take into account the practice of the parties.

- The executive orders/ decrees issued in the three foreign countries[12] (to grant the benefit of the lower tax rate of 5% on dividends after Columbia/ Slovenia/ Lithuania became OECD member countries) cannot be relied upon on the pretext that the manner of treaty assimilation into domestic law is radically different than what the Constitution of India mandates. In the aforesaid three foreign countries, ratification is required. However, in India, the treaty is required to be legislated or requires assimilation through a legislative device.

Dhruva Comments

The Supreme Court's judgement signifies the importance of Notification under Section 90(1) of the Act in implementation of DTAA and its Protocols.

This ruling will have a far-reaching implication (apart from dividend taxability) on the application of the MFN clause to various streams of income, notably in the cases of fees for technical services where 'make-available' benefits have been imported automatically based on a subsequent treaty which India may have entered into with an OECD member. In the absence of appropriate subsequent notification in relation to the changes that trigger pursuant to the MFN clause in these treaties, the benefit of the MFN clause may not be available. This could potentially give rise to significant tax demand together with interest on the Indian payer who had deducted tax basis lower rate of tax or restricted scope pursuant to the MFN clause. The ability of the Indian payer to recover such taxes and/ or interest from the recipients in cases where the tax was borne by the recipient especially where transactions have concluded will be tested.

As a fall out of such efforts, it would be interesting to see how the counterparties to the respective DTAAs with India react to the Supreme Court's Ruling and enter into bilateral negotiations with India for enforcement of MFN clause in entirety, especially where parties to the Treaty have agreed on '*self-operating MFN clause'*. It would also be interesting to view India's position on implementation of the MFN clause given the specific observation of the Supreme Court that

[12] the Netherlands, Switzerland and France.

© Copyright Dhruva Advisors LLP.

where Indian Parliament refuses to give effect to the DTAA (say a particular item of MFN clause is not notified), such DTAA continues to bind the Union, *leaving the Union in default*.

Contributors:

Abhishek Mundada (Partner)

Chirag Khetan (Principal)

Simran Punamiya (Senior Associate)

For any queries in relation to this alert, please feel free to contact us.

© Copyright Dhruva Advisors LLP.

www.dhruvaadvisors.com

Follow us on:

ADDRESSES

Mumbai
1101, One World Center,
11th floor, Tower 2B,
841 Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
402, 4th Floor, Venus Atlantis,
100 Feet Road,
Prahladnagar,
Ahmedabad 380015
Tel: +91-79-6134 3434

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana 122002
Tel: +91-124-668 7000

Pune
305, Pride Gateway,
Near D-Mart, Baner,
Pune 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal 700016
Tel: +91-33-66371000

Abu Dhabi
Dhruva Consultants
1905 Addax Tower, City of Lights
Al Reem Island,
Abu Dubai, UAE
Tel: +971 26780054

Dubai
Dhruva Consultants
Emaar Square Building 4, 2nd Floor,
Office 207, Downtown,
Dubai, UAE
Tel: +971 4 240 8477

KEY CONTACTS

Dinesh Kanabar
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Abhishek Mundada
Partner
abhishek.mundada@dhruvaadvisors.com

Dhruva Advisors has been consistently recognised as the “India Tax Firm of the Year” at the ITR Asia Tax Awards in 2017, 2018, 2019, 2020 and 2021.

Dhruva Advisors has also been recognised as the **“India Disputes and Litigation Firm of the Year”** at the ITR Asia Tax Awards 2018 and 2020.

WTS Dhruva Consultants has been recognised as the **“Best Newcomer Firm of the Year”** at the ITR European Tax Awards 2020.

Dhruva Advisors has been recognised as the **“Best Newcomer Firm of the Year”** at the ITR Asia Tax Awards 2016.

Dhruva Advisors has been consistently recognised as a **Tier 1 Firm in India for General Corporate Tax** by the International Tax Review’s in its World Tax Guide.

Dhruva Advisors has been consistently recognised as a **Tier 1 Firm in India for Indirect Taxes** in International Tax Review’s Indirect Tax Guide.

Dhruva Advisors has also been consistently recognised as a **Tier 1 Firm in India for its Transfer Pricing** practice ranking table in ITR’s World Transfer Pricing guide

Disclaimer:
This information contained herein is in summary form and is therefore intended for general guidance only. This publication is not intended to address the circumstances of any particular individual or entity. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation. This publication is not a substitute for detailed research and opinion. Before acting on any matters contained herein, reference should be made to subject matter experts and professional judgment needs to be exercised. Dhruva Advisors LLP cannot accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© Copyright Dhruva Advisors LLP.